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ANALYSIS OF NATIONAL EXPERIENCES IN HORIZONTAL AND VERTICAL DIVERSIFICATION, INCLUDING THE POSSIBILITIES FOR CROP SUBSTITUTION

MALAYSIA

Report of the UNCTAD secretariat

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CONTENTS

	Paragraphs
Foreword	1 - 4
Summary and conclusions	5 - 10
Chapter I	
THE EXPORT DIVERSIFICATION EXPERIENCE OF MALAYSIA	11 - 18
A. General export experience	11 - 12
B. Export composition	13 - 14
C. Export market diversification	15 - 18
Chapter II	
GENERAL POLICY ENVIRONMENT	19 - 73
A. General economic policy environment	19 - 33
1. Introduction	19 - 21
2. The NEP and direct government support	22 - 28
3. Development planning and indirect government support since the mid-1980s	29 - 33
B. Trade policy orientation	34 - 39
C. Market access conditions	40 - 43
D. Investment policy	44 - 56
1. Equity regulations	46 - 47
2. Investment by the Government	48 - 49
3. Investment incentives	50 - 51
4. Policy regarding foreign direct investment	52 - 56
E. Exchange-rate policy	57 - 58
F. Fiscal policy	59 - 60
G. Monetary policy	61 - 69
H. Policy regarding the cooperation between the Government and the private sector	70 - 73
Chapter III	
COMMODITY-SPECIFIC ISSUES RELATED TO MALAYSIA'S DIVERSIFICATION EXPERIENCE	74 - 111
A. Rubber products	74 - 81
B. Palm oil	82 - 97
1. General developments	82 - 87
2. Horizontal Diversification	88 - 91
3. Vertical Diversification	92 - 93
4. The Government's role in market regulations and marketing	94 - 96
5. Conclusion	97
C. Cocoa	98 - 104
D. Forestry products	105 - 111

	Pages
Annex I: The structure of main incentive schemes	64 - 66
Annex II: Malaysia's views on timber certification and labelling	67 - 69
References	70 - 71
Interviews	72

Page

Tables

1. Main Exports, 1970-1992, in per cent 9
2. Value added by manufacturing industries 10
3. Malaysia's exports by products and country of destination, 1970-1993 13-14
4. Main economic indicators of the Malaysian economy, 1970-1993 16
5. Production and export of pineapple, 1970-1993 18
6. Basic statistics on tin, 1970-1993 20
7. Nominal and effective rates of protection, 1982,1985,1987 25
8. Taxes on rubber and palm oil exports from Malaysia 27
9. Frequency and trade coverage ratios of non-tariff barriers facing exports from Malaysia in the European Union, Japan and the United States 28
10. Foreign Investment in approved projects by country and industry 35
11. Investment in approved projects by industry, 1993 and 1992 36
12. Export of rubber products by product group, 1980-1993 . . 45
13. Production,export and local refining of palm oil in Malaysia, 1965-1993 47
14. Export duty and duty exemption formula for palm oil . . . 51
15. Malaysia's exports of processed palm oil by main destinations, 1980 and 1993 52
16. Pre- and post-Uruguay Round tariff escalation in palm-oil trade 53
17. Basic statistics on cocoa, 1977-1993 56
18. Production and exports of major timber products by product group 1980-1993 58
19. Cess rates on exports of forestry products from Peninsular Malaysia 59

Text Boxes

1. Pineapples 18
2. Ducks rather than tin 20
3. Fishery, horticulture and floriculture sectors 23
4. Strengthening backward linkages: the Vendor Development Program (VDP) 61

Figures

1. Terms of trade index 1970-1993, 1980=100 8
2a. Malaysia's export by destination, 1970 12
2b. Malaysia's exports by destination, 1990 12
3. Private and public investment, 1970-1993 31
4. Number of investment projects approved, by ownership, 1980-1993 33
5. Evolution of exchange rate indices, 1970-1994, period averages 37

FOREWORD

1. The Committee on Commodities, at its fourteenth session in November 1990, decided that priority should be given to the study of the impact of market conditions in importing and exporting countries with regard to diversification. The analysis would include government policies, structural adjustment, forms and methods of trading, and technical assistance.[1] The Standing Committee on Commodities, at its first session in February 1993, decided, in the same vein, that national experiences in horizontal and vertical diversification, including possibilities for crop substitution, should be analyzed, and that the best ways of achieving diversification should be examined, taking into account competitiveness, market trends and opportunities.[2]

2. In accordance with these mandates, a number of country studies are being undertaken, namely in Cameroon, Colombia, Fiji, Malaysia, Senegal, Solomon Islands and the United Republic of Tanzania. The experience of these countries in the diversification of their commodity exports (including increased processing and diversification into commodity-related marketing activities) as well as the conditions influencing this are being analyzed. These conditions fall into two broad areas: the macroeconomic and international environment (including market access conditions), and the commodity specific supporting framework (in terms of services supplied by the Government or otherwise, infrastructure, market promotion support, etc.).

3. The approach attempts to identify the key policy factors which make commodity export diversification happen, or which hinder it. This covers questions such as the factors which led to and facilitated the introduction of new export-oriented productive activities; the problems these new activities encountered, and, if these problems were overcome, how this was done; if problems were not overcome, what were the gaps in the supporting environment, and in particular, the government policies. It is difficult to assess the impact of each policy measure separately; their complementary nature and the influence of weather conditions on agriculture production weigh heavily as factors. The studies thus attempt to specify which package of conditions makes export diversification viable, and which package of policy measures seems to enhance the chances of export diversification success.

4. These studies do not attempt to formulate general theoretical statements or specific policy recommendations for the countries studied. Rather, the objective is to draw conclusions on the sorts of policies that would facilitate diversification, the support services required to enable local entrepreneurs to make use of existing possibilities, and the ways a country can draw maximum benefits from the marketing of its commodities. Presently, many countries are undergoing policy reform; diversification of exports is generally one of the goals and envisaged outcomes. However, the resources available to stimulate diversification are always scarce; in general, countries do not have the information necessary to determine how to use their resources optimally. These studies are intended, therefore, to support the process of policy formulation in developing countries in this area.

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[1] TD/B/C.1/L.96, 21 November 1990, para. 12.

[2] "Establishment of the work programme of the Standing Committee", TD/B/CN.1/8, 3 February 1993.

SUMMARY AND CONCLUSIONS

5. The composition of exports from Malaysia has changed drastically over the last three decades. While three largely unprocessed primary commodities (rubber, tin and sawn logs) accounted for about 80 per cent of Malaysia's export earnings in 1970, about half of the country's export earnings came from manufactures during the early 1990s. Three main phases of export diversification can be distinguished: diversification into palm oil and textiles during the 1970s; diversification into cocoa during the early 1980s; and diversification into rubber-based products, wearing apparel, furniture and electrical machinery since the mid-1980s. At the same time, other Asian countries, in particular the Newly Industrialized Economies (NIEs), have become increasingly important as Malaysia's export destination.

6. Malaysia's economic policy has been strongly influenced by the Government's objectives to eradicate poverty and eliminate the identification of race with economic function. These goals were set in the aftermath of the ethnic riots of May 1969. They have been translated into affirmative action in favour of the indigenous Malays (Bumiputras). Emphasizing agricultural development is a natural consequence of this strategy, given that the main part of this group of the population lives in rural areas. Agricultural development has been focused initially on new land development. This has been facilitated by Malaysia's relatively small population and the availability of relatively ample new land; Malaysia could therefore avoid equity problems common to many other developing countries with highly uneven land distribution. New land development had to be increasingly combined with measures designed to raise productivity of land and labour because an increase in agricultural income - despite a substantial rise in absolute terms - has lagged relative to that of the industrial sector. The result has been labour shortages in rural areas and abandoned land. The Government took steps to strengthen research and development activities in the agricultural sector in order to develop high-yielding crop varieties, improve drainage, harvesting techniques, etc. This has given incentives to farmers to develop off-farm income sources. In addition, diversification into crops with better market prospects than the traditional rubber - such as first palm oil and then cocoa - were encouraged. This has been done for example, through flexible management of replanting grants. Furthermore, the inflow of semi-legal immigrant workers providing cheap labour to estate plantations has been tolerated.

7. The development of industrial manufacturing has contributed significantly to output and employment generation. Growth in this sector has been supported by a small degree of tariff protection and, in particular over the last ten years, by a massive inflow of foreign direct investment. This inflow was spurred on by a change in equity regulations making complete equity ownership possible for foreigners and by favourable external factors, in particular increases in production costs in Japan and the NIEs. Industrial growth has, however, been associated with several structural weaknesses: (a) it is narrowly concentrated in two sectors, namely electronics and wearing apparel, and (b) its geographical location in the free trade zones means little inter-industry and inter-sectoral linkages with the rest of the economy. The authorities have sought to address this problem through the incentives given to small- and medium-sized enterprises, for example, and the creation of the Vendor Development Scheme (see box 4). The share of value-added from resource-based industries in total domestic-value added has continued to exceed these industries' share in total gross foreign-exchange earnings from merchandise exports, suggesting that in terms of value-added the Malaysian economy still benefits from natural-resource-based sectors more than from industrial

manufacturing. The close link between foreign direct investment (FDI) and export destination suggests that FDI has had a strong impact on the structure of Malaysia's exports.

8. Commodity-specific diversification can be summarized as follows:

- In line with the New Economic Policy (NEP), the plantation area covered by oil palms has increased substantially while the outcome of research and development activities has allowed for a steep increase in productivity and the development of processing activities, including new end-uses for processed palm-oil products; sliding export taxes have played an important role in vertical diversification; the success of these activities has also been firmly rooted in the strong expansion of world demand for palm oil;

- Diversification into cocoa was initiated mainly by the price responsiveness of farmers and sustained by government-sponsored research which led to the availability of high-yielding hybrids; the resulting high productivity has made cocoa growing profitable even during the period of low prices on the world cocoa market in the 1980s; quality improvements, stable climatic conditions, and a favourable geographical location with respect to emerging markets for cocoa products have been the strongest factors behind the successful attraction of foreign investment which has helped spur vertical diversification in the cocoa sector;

- Diversification into rubber-based products (examination gloves and tires) has been the result mainly of the buoyant demand on the world market for latex products in recent years, the easy access to raw material and the conscious policy of granting favourable investment possibilities to foreign investors; the Government has also provided for specific financial advantages for producers and exporters of rubber-based products between 1985 and 1990;

- Diversification into forestry products (veneer sheets and furniture) has been encouraged by the Government through a partial ban on the export of logs and the provision of sector-specific tax incentives, including to foreign investors.

9. The successful diversification of Malaysia's commodity exports seems to have been the result of five main factors:

- The strategy of pursuing the creation of growth with equity and employment as the central objectives of economic policy; that this strategy has led to export diversification can be attributed in large measure to two factos: (a) successful affirmative action in favour of Bumiputras has required substantial income increases in agriculture and resource-based industries; and (b) foreign direct investment - being the driving force of export-oriented industrial development in Malaysia - has focused on electronics and wearing apparel;

- The encouragement of investment; the Government has pursued sound macroeconomic policies and largely abandoned protectionist policies when they started to impinge on macroeconomic stability; it provided adequate physical infrastructure complementary to private investment; it followed an investment-friendly policy through a tax policy favouring investment; it at times pursued mild financial repression; it established lending guidelines for commercial banks in favour of Bumiputras and priority economic sectors. The Government has also operated innovative export-

related financial facilities, which has helped in penetrating new markets, particularly in other developing countries;

- A relatively favourable external environment regarding the evolution of world demand for the commodities into which the country was diversifying had a considerable impact.

- The most important lesson to be learned from Malaysia's experience in export diversification may well be the role research and development has played, whether by the private sector and financially supported by the Government or executed by the Government itself. An interesting feature of these activities is that they have been financed from within the respective commodity sector, through a levy on either production (palm oil) or production and exports (rubber). Research and development has been crucial to ensuring maintenance of the supply capacity of the Malaysian economy and the competitiveness of Malaysian exporters, in terms of both price and quality. Above all, the commercially applicable output of agricultural research has helped keep within manageable limits the divergence in the evolution of productivity between the agricultural and industrial sectors. Contrary to the experience of many other developing countries, this has stemmed the marginalization of rural areas and significantly increased the competitiveness of agricultural products from Malaysia on world markets. The country's rubber, palm oil and cocoa plantations are among the best run and most productive in the world. Research and development has also allowed new end-uses of commodities to be developed and has facilitated domestic processing activities. The latter, in turn, have raised the skill level of the domestic labour force gradually, thus helping to narrow the gap between the actual skill level of the labour force and that required by foreign investors to initiate activities which allow for a transfer of technology and a trickling down of new technology for spreading the benefits to a wider part of the Malaysian economy.

- Close cooperation between the Government and the private sector, in particular since the mid-1980s, has been a crucial determinant of research-and-development activities leading to commercially applicable results. The general economic policy, e.g. open towards foreign investors, also takes due account of the needs of the domestic business community; institutional partnerships between the Government and the business community in associations overseeing commodity-specific sectors as well as in dialogue sessions and cooperation within the Business Council have been conducive to economic development and diversification without yielding unduly to interest-group-specific lobbying.

10. The judicious combination of these factors may be considered the magic 'elixir' of Malaysia's diversification experience. The institutional capacity required for the implementation of the policy mix adopted by the Government, as well as the astuteness of the business community, the rich natural resource endownment and the favourable external environment for commodity exports may not always be readily available to other developing countries. Replicating Malaysia's experience may thus prove problematic; however, the country's experience suggests that tackling research-and-development issues may be crucial for developing countries aiming to diversify.

Chapter I

The export diversification experience of Malaysia

A. General export experience

11. Malaysia has been one of the most open economies in the developing world and international trade has played an increasingly important role in the country's economic development. In 1993, exports and imports were equivalent to 77 per cent and 74 per cent, respectively, of GNP, compared to 55 and 46 per cent in 1980 and 44 and 36 per cent in 1970, respectively.[3] The economy has, therefore, been quite vulnerable to externally induced fluctuations, in particular price swings on world commodity markets. For example, as figure 1 shows, Malaysia's terms of trade improved by almost 15 per cent during the period 1977-1980 - the country's export receipts nearly doubled - while they fell by almost 15 per cent over the following two years, then dropped again by 35 per cent by 1986. This development was the result mainly of rising prices for the country's main export commodities, including palm oil, rubber, timber and petroleum, in the former period, and the turn-around of the commodity price cycle during the latter period [see *UNCTAD Commodity Yearbook*]. Malaysia has, nonetheless, not experienced chronic external imbalances, as current account deficits have often been offset by investment inflows in the capital account.

Source: UNCTAD *Handbook of International Trade and Development*, various issues, Table 7.2

12. Parallel to the significant increase in the ratio of exports and imports to GNP over the last two decades, the composition of exports also changed dramatically, with manufactures[4] occupying an increasingly important position in the country's export basket.

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[3] See table 4 in chapter II for the main economic indicators of the Malaysian economy.

[4] Note that, unlike this study, Malaysian statistics consider processed forms of primary commodities, such as canned fruits, and products of cocoa, rubber, wood and tin, as "manufactures".

Table 1: Main exports, 1970-1992, total exports in milion of MS, individual exports in per cent

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Total Exports	1,686	3,831	12,945	11,770	12,030	14,130	16,590	15,442	13,753	17,939	21,110	25,053	29,416	34,349	40,705
Main primary and processed prim. products	**86.7**	**78.9**	**72.7**	**72.6**	**70.5**	**69.9**	**64.0**	**66.7**	**59.0**	**57.2**	**51.8**	**45.3**	**41.6**	**36.4**	**28.5**
Rubber	33.7	22.7	16.7	14.0	9.8	11.5	9.7	7.8	9.4	9.2	10.1	6.4	4.4	3.5	3.0
Natural rubber	*33.4*	*22.2*	*16.4*	*13.7*	*9.5*	*11.2*	*9.4*	*7.5*	*9.0*	*8.7*	*9.5*	*5.8*	*3.8*	*2.8*	*2.3*
Rubber products	*0.3*	*0.5*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.4*	*0.5*	*0.6*	*0.6*	*0.6*	*0.7*	*0.7*
Tin unwrought	19.5	13.1	8.9	7.9	5.3	5.2	3.0	4.3	1.8	1.9	1.7	1.7	1.1	0.7	0.7
Wood	18.1	14.2	15.6	14.5	17.7	16.0	9.6	11.2	12.9	14.8	12.8	12.9	11.3	10.0	6.6
Saw logs	*12.5*	*7.3*	*9.3*	*9.0*	*12.0*	*10.0*	*5.2*	*7.2*	*8.1*	*9.4*	*7.3*	*6.4*	*5.1*	*4.3*	*n.a.*
Rough wood	*4.2*	*5.1*	*4.9*	*3.8*	*4.3*	*4.3*	*3.0*	*2.7*	*3.5*	*3.8*	*3.5*	*4.4*	*3.9*	*3.1*	*3.4*
Plywood	*1.0*	*1.2*	*1.0*	*1.1*	*0.9*	*0.8*	*0.5*	*0.5*	*0.8*	*1.1*	*1.2*	*1.1*	*1.1*	*1.1*	*1.3*
Veneer sheets	*0.1*	*0.2*	*0.1*	*0.2*	*0.2*	*0.6*	*0.6*	*0.5*	*0.2*	*0.2*	*0.2*	*0.2*	*0.3*	*0.3*	*0.5*
Wood products	*0.3*	*0.3*	*0.2*	*0.3*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.3*	*0.3*	*0.3*	*0.4*	*0.4*
Furniture	*0.0*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.3*	*0.5*	*0.6*	*0.8*	*1.0*
Petroleum	7.9	11.2	20.0	23.7	25.8	23.4	22.8	24.6	17.3	15.8	12.3	11.6	13.4	11.2	7.9
Crude	*4.1*	*8.6*	*19.2*	*22.7*	*24.6*	*21.4*	*20.2*	*21.7*	*15.2*	*14.0*	*11.1*	*10.5*	*12.4*	*11.2*	*7.9*
Refined	*3.8*	*2.6*	*0.8*	*1.0*	*1.2*	*2.0*	*2.6*	*2.9*	*2.1*	*1.8*	*1.2*	*1.1*	*1.0*	*n.a.*	*n.a.*
Palm Oil	5.1	14.7	8.9	10.1	9.5	9.1	11.7	10.3	8.5	7.3	8.2	6.9	5.5	5.3	5.2
Pepper	1.1	1.2	0.4	0.3	0.2	0.2	0.2	0.4	0.5	0.4	0.3	0.2	0.2	0.1	0.1
Pineapples, tinned and juice	0.9	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Cocoa	0.1	0.4	0.7	0.8	0.9	0.8	1.2	1.4	1.7	1.8	1.6	1.0	0.9	0.6	0.6
Cocoa beans	*0.1*	*0.4*	*0.6*	*0.6*	*0.7*	*0.7*	*0.9*	*1.1*	*1.4*	*1.5*	*1.3*	*0.8*	*0.6*	*0.4*	*0.3*
Cocoa butter	*0.0*	*0.0*	*0.1*	*0.2*	*0.2*	*0.1*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.2*	*0.3*	*0.2*	*0.3*
Textile yarn and fabrics	0.3	0.8	1.3	1.1	1.1	1.0	1.0	1.0	1.3	1.3	1.1	1.2	1.2	1.3	1.4
Liquified natural gas	0.0	0.0	0.0	0.0	0.0	2.5	4.6	5.5	5.4	4.5	3.5	3.2	3.4	3.5	2.8
Main manufactures	n.a.	n.a.	11.8	12.6	14.9	16.2	17.9	16.8	24.9	25.8	29.1	33.1	36.8	40.6	42.7
Apparel and clothing acc.	0.3	1.1	1.2	1.4	1.5	1.5	1.8	2.0	3.0	3.4	3.9	4.3	4.5	4.5	4.6
Machineries	0.0	0.0	9.9	10.9	13.3	14.6	16.0	14.7	21.8	22.3	24.8	28.1	31.0	34.6	36.7
Office machines	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.2*	*0.2*	*0.1*	*0.2*	*0.3*	*1.0*	*2.3*	*4.0*	*5.8*
Sound recorders	*0.0*	*0.0*	*0.8*	*0.8*	*1.3*	*1.8*	*1.9*	*1.5*	*3.8*	*4.9*	*6.5*	*9.2*	*10.9*	*12.9*	*13.2*
Electrical machinery	*n.a.*	*n.a.*	*9.1*	*10.1*	*12.0*	*12.8*	*13.9*	*13.0*	*17.9*	*17.2*	*18.0*	*17.9*	*17.8*	*17.7*	*17.7*
Transport equipment	n.a.	n.a.	0.7	0.2	0.6	0.9	1.4	1.4	1.3	1.3	0.8	1.4	2.0	3.0	3.0
Gold and silverware	0.0	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.7	1.3	1.5	1.4
Others	**13.0**	**19.9**	**15.5**	**14.8**	**14.0**	**13.0**	**16.7**	**15.1**	**15.7**	**15.7**	**18.4**	**20.3**	**19.7**	**20.1**	**25.9**

Source : UNCTAD database

B. Export composition

13. Table 1 shows that, in 1970, the bulk (86.4 per cent) of Malaysia's export earnings came from primary commodities. Within this product group, three largely unprocessed commodities - namely natural rubber, unwrought tin and saw logs - were responsible for about 80 per cent of export earnings. During the 1970s, the share of timber exports dropped significantly while that of rubber and tin exports more than halved. Conversely, export earnings from petroleum, palm oil and textiles doubled. At the same time, light manufactures such as wearing apparel and machinery assembling became increasingly more important earners of foreign-exchange. During the 1980s, the importance of rubber, tin and timber exports continued to decline. During the early 1980s, exports of cocoa and natural liquified gas had experienced a substantial rise, while the importance of exports of rubber-based products, apparel, footwear and, in particular, electrical machinery and sound recording equipment has grown vigorously since the mid-1980s.

Table 2: Value added by manufacturing industries

	values [RM mn]					composition [per cent]				
	1973	1981	1984	1987	1990	1973	1981	1984	1987	1990
Processing of estate-type agricul. production in factories off estates (1)	n.a.	978	1,301	1,061	1,128	n.a.	10.3	10.6	8.0	4.6
Food	364	837	961	1,119	1,489	15.7	8.8	7.8	8.4	6.1
Beverages	61	305	284	313	544	2.6	3.2	2.3	2.4	2.2
Tobacco products	130	272	352	535	345	5.6	2.9	2.9	4.0	1.4
Textiles	104	408	419	545	804	4.5	4.3	3.4	4.1	3.3
Footwear (except rubber footwear), other wearing apparel and made-up textile goods	36	231	244	377	769	1.5	2.4	2.0	2.8	3.1
Wood products	304	871	709	867	1,580	13.1	9.2	5.8	6.5	6.4
Furniture and fixtures	19	52	81	90	189	0.8	0.5	0.7	0.7	0.8
Printing, publishing and allied industr.	115	414	535	440	719	4.9	4.4	4.3	3.3	2.9
Paper and paper products	18	94	125	168	420	0.8	1.0	1.0	1.3	1.7
Leather and leather products	3	7	7	6	17	0.1	0.1	0.1	0.0	0.1
Rubber products	223	377	406	517	1,151	9.6	4.0	3.3	3.9	4.7
Chemicals and chemical products	175	462	1,788	1,955	2,650	7.5	4.9	14.5	14.7	10.8
Products of petroleum and coal	52	545	249	294	626	2.2	5.7	2.0	2.2	2.6
Non-metallic mineral products	104	487	743	651	1,192	4.5	5.1	6.0	4.9	4.9
Basic metal industries	86	313	412	504	947	3.7	3.3	3.3	3.8	3.9
Metal products	114	388	357	370	855	4.9	4.1	2.9	2.8	3.5
Machinery except electrical machinery	87	330	314	330	943	3.7	3.5	2.6	2.5	3.8
Eletrical machinery	189	1,235	2,021	2,147	5,262	8.1	13.1	16.4	16.1	21.5
Transport equipment	62	441	569	380	1,336	2.7	4.6	4.6	2.9	5.4
Misc. manufacturing industries	80	395	424	648	1,564	3.4	4.2	3.4	4.9	6.4
Total	2,327	9,490	12,301	13,317	24,530	100.0	100.0	100.0	100.0	100.0

Note: (1) Have been distributed to food and rubber products from 1973 census and subsequent surveys, up to 1978.
Source: *Bank Negara Malaysia, Quarterly Bulletin, December 1993, page P-75.*

14. These developments resulted in a radical change in Malaysia's export structure. Over the last few years, main primary and processed primary commodities have accounted for only 30-35 per cent of total exports, compared to a share of about 40 per cent of main manufactured exports. Export items of minor importance from both the commodity and manufactured sectors have been responsible for the remainder. In addition, there is no longer any single commodity with a share of more than 25 per cent in total export earnings. However, manufactured exports largely come from the Free Trade Zones which rely heavily on FDI in wearing apparel and electrical and electronic products; electrical and electronic products account for over 80 per cent of export earnings from manufactures. Given the high import component in electronics production, net foreign exchange earnings from manufactured exports have been relatively low. Table 2 shows that the value-added of the electrical-machinery sector was only 20 per cent in 1990. The table also suggests that the value added obtained from natural-resource-based industries such as processed food and wood and rubber products has substantially increased and outpaced the growth of the share in total gross export earnings that these goods achieved over the last five years, as suggested by table 1. This suggests that linkages associated with the production of electrical and electronic machinery are relatively weak and that, in terms of value-added, the Malaysian economy still benefits from natural-resource-based sectors more than from industrial manufacturing.

C. Export market diversification

15. The destination of Malaysia's exports has remained relatively unchanged over the last two or three decades, with over 80 per cent of the country's exports going to other ASEAN-countries, the United States, Japan, the European Union and East Asia. However, a significant evolution in the destination of Malaysia's exports within this group of countries has been the growing share of other Asian developing countries. Figures 2a and 2b suggest that the share of ASEAN members, NIEs and the People's Republic of China grew from 32 per cent in 1970 to 41 per cent in 1990, with the share of the NIEs doubling. On an individual country basis, Singapore was the main destination of Malaysia's exports in 1990 with 23 per cent of total exports, followed by the United States (17 per cent), Japan (15 per cent), the United Kingdom (4 per cent), Germany (4 per cent), and Hong Kong (3 per cent) as the other main export destinations. Regarding changes in the shares of individual countries or regions over the last 20 years, the figures show that (i) the share of exports to Japan fell from 18 per cent in 1970 to 15 per cent in 1990; (ii) the share of the European Union as a group of countries fell from 20 per cent to 15 per cent; (iii) the share of the NIEs doubled, rising from 5 to 10 per cent; and (iv) the share of the United States rose from 13 per cent to 17 per cent over the same period.

16. Malaysia has also been successful in developing new markets in other developing countries, with the result that in 1993 total exports to those countries accounted for 10 per cent of total exports. Commodities accounted for the bulk of these exports, for example, palm oil to India, Islamic Republic of Iran and Iraq; rubber to Brazil, Argentina and Zimbabwe; and petroleum to Chile. In order to increase exports to these countries, the Government, i.e., the Ministry of International Trade and Industry, entered into an agreement with three major Malaysian companies in 1994 to implement a scheme designed to promote trade and economic linkages with countries of the South. Under this scheme, MITI allocated 2 million ringgit Malaysia to each of these companies to be utilized for feasibility studies, fact-finding missions, marketing visits, etc. with a view to putting into place an action programme on market development

in countries of the South. The Government has become involved in this endeavour with a view to obtaining better terms and ensure quicker results [MITI (1994, pp. 152-153)].

Figure 2a: Malaysia's exports by destination, 1970

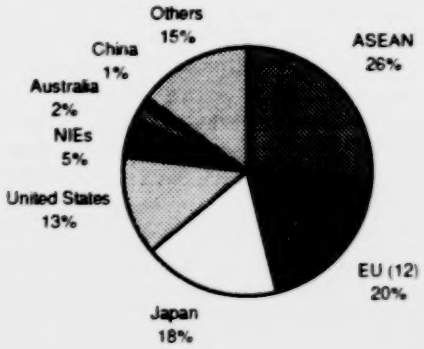
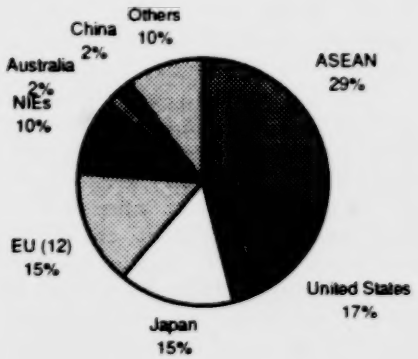


Figure 2b: Malaysia's exports by destination, 1990



Source: International Monetary Fund, Direction of Trade Statistics, various issues.

Notes: NIEs include Hong Kong, Republic of Korea and Taiwan Province of China. ASEAN includes Indonesia, the Philippines, Singapore and Thailand. EU = European Union.

Table 3: Malaysia's exports by product and country of destination, 1970-1993, percentage shares in product totals

	1970	1975	1980	1985	1987	1991	1992	1993
Rubber, natural	100	100	100	100	100	100 3)	100	100
EEC	*n.a.*	*n.a.*	*27.8*	*27.9*	*26.1*	*26.0 3)*	*30.0*	*28.7*
Japan	*n.a.*	*n.a.*	*4.1*	*6.2*	*5.5*	*7.8 3)*	*7.5*	*7.1*
USSR/CIS	*n.a.*	*n.a.*	*6.8*	*6.2*	*4.9*	*5.4 3)*	*1.1*	*0.0*
China	*n.a.*	*n.a.*	*5.9*	*5.5*	*9.6*	*6.1 3)*	*2.5*	*1.9*
Rep. of Korea	*n.a.*	*n.a.*	*3.9*	*7.5*	*9.4*	*12.2 3)*	*12.6*	*13.7*
Singapore	*25.3*	*25.7*	*25.9*	*11.7*	*11.0*	*8.5 3)*	*6.3*	*5.1*
United States	*11.6*	*11.2*	*7.6*	*9.9*	*9.0*	*9.7 3)*	*13.2*	*14.3*
Others	*63.1*	*63.1*	*17.9*	*25.2*	*24.6*	*24.4 3)*	*26.8*	*29.3*
Sawlogs	100	100	100	100	100	100	100	100
Japan	*n.a.*	*n.a.*	*67.4*	*66.1*	*64.5*	*54.2*	*54.9*	*65.4*
Taiwan Prov. of China	*n.a.*	*n.a.*	*13.4*	*11.8*	*8.5*	*14.0*	*14.8*	*11.0*
Rep. of Korea	*n.a.*	*n.a.*	*11.6*	*14.5*	*13.2*	*16.0*	*10.4*	*9.6*
China	*n.a.*	*n.a.*	*3.9*	*4.5*	*3.0*	*5.6*	*7.2*	*6.0*
Others	*n.a.*	*n.a.*	*3.6*	*3.2*	*10.8*	*10.2*	*12.7*	*8.0*
Sawn timber	100	100	100	100	100	100	100	100
EEC	*n.a.*	*n.a.*	*45.1*	*45.1*	*48.9*	*36.2*	*32.2*	*26.0*
Japan	*n.a.*	*n.a.*	*5.0*	*9.9*	*10.3*	*13.2*	*14.5*	*15.3*
Singapore	*n.a.*	*n.a.*	*21.6*	*14.5*	*14.4*	*8.4*	*6.7*	*5.6*
China	*n.a.*	*n.a.*	*0.0*	*0.0*	*0.6*	*1.2*	*2.4*	*2.3*
Others			*28.3*	*30.5*	*25.8*	*41.1*	*44.2*	*50.8*
Plywood	100	100	100	100	100	100	100	100
China	*n.a.*	*n.a.*	*0.0*	*0.0*	*6.3*	*14.3*	*18.5*	*29.4*
Japan	*n.a.*	*n.a.*	*2.9*	*2.1*	*1.0*	*3.7*	*6.2*	*18.7*
Singapore	*n.a.*	*n.a.*	*43.4*	*37.0*	*44.1*	*34.1*	*23.5*	*14.4*
Hong Kong	*n.a.*	*n.a.*	*10.0*	*11.5*	*10.6*	*7.3*	*6.9*	*8.8*
United States	*n.a.*	*n.a.*	*3.2*	*2.6*	*6.5*	*9.6*	*10.8*	*7.5*
EEC	*n.a.*	*n.a.*	*25.8*	*26.6*	*19.8*	*13.0*	*11.3*	*5.7*
Others	*n.a.*	*n.a.*	*14.7*	*20.3*	*11.7*	*18.1*	*22.9*	*15.5*
Veneer	100	100	100	100	100	100	100	100
China	*n.a.*	*n.a.*	*0.0*	*0.0*	*3.7*	*11.3*	*31.6*	*32.6*
Japan	*n.a.*	*n.a.*	*21.6*	*42.3*	*53.0*	*54.9*	*28.7*	*30.5*
Taiwan Prov. of China	*n.a.*	*n.a.*	*0.5*	*5.2*	*16.5*	*25.0*	*29.3*	*23.1*
Rep. of Korea	*n.a.*	*n.a.*	*0.0*	*19.0*	*0.0*	*0.9*	*1.8*	*3.4*
Hong Kong	*n.a.*	*n.a.*	*1.1*	*0.0*	*0.0*	*0.0*	*0.2*	*2.0*
Singapore	*n.a.*	*n.a.*	*54.1*	*11.3*	*9.6*	*2.6*	*3.5*	*1.4*
EEC	*n.a.*	*n.a.*	*13.5*	*4.8*	*4.2*	*1.4*	*1.0*	*1.0*
Others	*n.a.*	*n.a.*	*9.2*	*17.5*	*11.0*	*4.0*	*3.9*	*6.0*
Wooden furniture	100	100	100 1)	100	100	100	100	100
United States	*n.a.*	*n.a.*	*53.3 1)*	*17.6*	*24.4*	*32.3*	*32.0*	*41.4*
Japan	*n.a.*	*n.a.*	*1.3 1)*	*0.8*	*2.7*	*20.1*	*20.9*	*20.4*
Singapore	*n.a.*	*n.a.*	*8.0 1)*	*40.0*	*25.3*	*14.6*	*15.6*	*13.2*
Australia	*n.a.*	*n.a.*	*22.0 1)*	*24.0*	*9.3*	*5.6*	*5.7*	*3.7*
Others	*n.a.*	*n.a.*	*15.3 1)*	*17.6*	*38.2*	*27.3*	*25.9*	*21.3*
Petroleum, crude	100	100	100	100	100	100 3)	100	100
Japan	*n.a.*	*36.2*	*n.a.*	*n.a.*	*19.8*	*18.8 3)*	*17.6*	*14.5*
Philippines	*18.8*	*12.4*	*n.a.*	*n.a.*	*n.a.*	*n.a. 3)*	*n.a.*	*n.a.*
Rep. of Korea	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*14.1*	*13.0 3)*	*15.1*	*16.1*
Singapore	*46.3*	*29.3*	*n.a.*	*n.a.*	*32.4*	*26.8 3)*	*23.4*	*24.6*
Thailand	*7.1*	*11.1*	*n.a.*	*n.a.*	*6.4*	*12.6 3)*	*14.4*	*19.5*
Others	*27.8*	*11.0*	*n.a.*	*n.a.*	*27.3*	*28.9 3)*	*29.6*	*25.3*
Tin	100	100	100	100	100	100 3)	100	100
EEC	*n.a.*	*n.a.*	*36.4*	*73.1*	*23.8*	*25.9 3)*	*37.3*	*29.4*
Korea	*n.a.*	*n.a.*	*1.3*	*0.5*	*5.5*	*9.6 3)*	*8.7*	*12.9*
Taiwan Prov. of China	*n.a.*	*n.a.*	*0.8*	*0.8*	*4.6*	*6.1 3)*	*6.9*	*10.0*
Australia	*n.a.*	*n.a.*	*0.2*	*0.4*	*3.1*	*4.2 3)*	*4.9*	*5.7*
USSR/CIS	*n.a.*	*n.a.*	*9.3*	*3.6*	*6.1*	*0.0 3)*	*0.0*	*0.0*
Japan	*26.9*	*13.6*	*26.2*	*17.0*	*29.7*	*28.1 3)*	*20.8*	*22.9*
United States	*36.8*	*n.a.*	*15.2*	*0.8*	*6.9*	*7.5 3)*	*5.0*	*4.3*
Singapore	*0.2*	*0.6*	*1.4*	*0.1*	*12.5*	*9.5 3)*	*3.9*	*3.3*
India	*n.a.*	*n.a.*	*3.0*	*0.8*	*3.6*	*2.8 3)*	*3.2*	*5.1*
Others	*36.1*	*85.8*	*6.1*	*2.7*	*4.2*	*6.3 3)*	*9.3*	*6.3*

Table 3 cont'd: Malaysia's exports by product and country of destination, 1970-1993, percentage shares in product totals

	1970	1975	1980	1985	1987	1991	1992	1993
Palm oil, crude and refin	100	100	100	100	100	100 3)	100	100
Japan	*n.a.*	*n.a.*	*6.7*	*6.3*	*5.5*	*4.8 3)*	*5.6*	*5.8*
Singapore	*30.6*	*n.a.*	*28.3*	*30.1*	*14.0*	*13.1 3)*	*13.0*	*8.9*
United States	*5.3*	*26.8*	*4.2*	*4.0*	*4.0*	*2.3 3)*	*3.6*	*4.1*
EEC	*n.a.*	*n.a.*	*14.9*	*6.7*	*7.2*	*7.9 3)*	*10.7*	*8.3*
China	*n.a.*	*n.a.*	*2.1*	*1.0*	*2.0*	*17.0 3)*	*10.5*	*13.2*
Pakistan	*n.a.*	*n.a.*	*5.6*	*6.5*	*10.5*	*10.9 3)*	*15.5*	*17.2*
India	*n.a.*	*n.a.*	*19.3*	*20.6*	*25.5*	*9.0 3)*	*2.2*	*1.2*
Egypt	*n.a.*	*n.a.*	*0.0*	*0.0*	*0.0*	*5.9 3)*	*5.0*	*6.7*
Others	*64.1*	*73.2*	*19.0*	*24.8*	*31.3*	*29.1 3)*	*33.8*	*34.7*
Pineapple, canned	100	100	100	100	100	100	100	100
Middle East	*n.a.*	*n.a.*	*22.3*	*14.0*	*22.2*	*18.1*	*17.3*	*27.2*
Japan	*n.a.*	*n.a.*	*7.5*	*16.3*	*9.6*	*31.6*	*23.1*	*24.1*
United States	*n.a.*	*n.a.*	*17.6*	*17.3*	*22.0*	*10.8*	*8.4*	*11.4*
United Kingdom	*n.a.*	*n.a.*	*33.7*	*16.1*	*14.1*	*9.4*	*9.1*	*5.9*
Germany	*n.a.*	*n.a.*	*4.2*	*15.3*	*2.2*	*5.4*	*5.6*	*5.5*
New Zealand	*n.a.*	*n.a.*	*5.4*	*5.4*	*2.1*	*1.1*	*0.3*	*0*
Canada	*n.a.*	*n.a.*	*2.1*	*1.0*	*2.5*	*0.0*	*0.0*	*0*
Others	*n.a.*	*n.a.*	*7.1*	*14.5*	*25.3*	*23.7*	*32.5*	*25.9*
Cocoa, beans	100	100	100	100	100	100	100	100
Singapore	*n.a.*	*n.a.*	*35.2*	*48.4*	*39.7*	*37.6*	*42.9*	*28.6*
EEC	*n.a.*	*n.a.*	*45.6*	*41.6*	*51.6*	*27.0*	*20.0*	*42.6*
Australia	*n.a.*	*n.a.*	*6.2*	*1.1*	*0.8*	*0.0*	*0.0*	*0.0*
China	*n.a.*	*n.a.*	*0.2*	*2.4*	*1.0*	*12.4*	*14.1*	*17.0*
Japan	*n.a.*	*n.a.*	*2.5*	*2.3*	*1.8*	*2.6*	*2.6*	*2.4*
United States	*n.a.*	*n.a.*	*7.2*	*1.6*	*4.0*	*14.4*	*16.8*	*7.2*
Others	*n.a.*	*n.a.*	*3.2*	*2.6*	*1.0*	*6.1*	*3.7*	*2.2*
Cocoa, butter	100	100	100	100	100	100	100	100
USA	*n.a.*	*n.a.*	*31.3*	*54.9*	*48.0*	*56.2*	*47.2*	*20.9*
EEC	*n.a.*	*n.a.*	*31.4*	*19.0*	*25.1*	*26.2*	*31.3*	*57.7*
Australia	*n.a.*	*n.a.*	*6.1*	*18.1*	*12.1*	*10.1*	*10.7*	*9.6*
Japan	*n.a.*	*n.a.*	*4.0*	*4.2*	*2.9*	*2.7*	*4.0*	*3.8*
Singapore	*n.a.*	*n.a.*	*27.1*	*1.9*	*1.1*	*1.4*	*0.8*	*1.3*
Others	*n.a.*	*n.a.*	*0.1*	*1.8*	*10.9*	*3.4*	*6.1*	*6.7*
Textiles	100	100	100	100	100 2)	100 3)	100	100
United States	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*10.5 2)*	*9.6 3)*	*11.5*	*9.5*
European Union	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*15.5 2)*	*14.7 3)*	*14.4*	*14.5*
Singapore	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*13.5 2)*	*16.8 3)*	*19.6*	*16.8*
Hong Kong	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*6.8 2)*	*6.5 3)*	*13.2*	*15.9*
Japan	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*2.2 2)*	*6.6 3)*	*7.6*	*6.7*
Others	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*51.5 2)*	*45.8 3)*	*33.7*	*36.6*
Clothing	100	100	100	100	100 2)	100 3)	100	100
United States	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*56.3 2)*	*42.3 3)*	*44.2*	*47.5*
European Union	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*28.5 2)*	*36.7 3)*	*36.0*	*33.7*
Canada	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*3.3 2)*	*4.0 3)*	*3.1*	*3.1*
Singapore	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*2.9 2)*	*6.0 3)*	*7.3*	*5.6*
Japan	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*1.8 2)*	*2.8 3)*	*2.5*	*3*
Others	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*7.1 2)*	*8.3 3)*	*6.8*	*7.1*
Electrical machinery	100	100	100	100	100	100	100	100
Hong Kong	*n.a.*	*3.5*	n.a.	n.a.	n.a.	n.a.	n.a.	*7.9*
Japan	*n.a.*	*6.6*	n.a.	n.a.	n.a.	n.a.	n.a.	*9.6*
Singapore	*34.8*	*18.9*	n.a.	n.a.	n.a.	n.a.	n.a.	*18.3*
United States	*n.a.*	*54.6*	n.a.	n.a.	n.a.	n.a.	n.a.	*37.5*
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	*26.7*

Sources: Ariff (1991a, pp. 61-62), Ministry of Primary Industries (1988b, 1994b), Ministry of Finance (1994, pp. xxvi-xxvii, and p. 132) and MITI (1994, p. 49)
Notes: 1) 1982; 2) 1988; 3) 1990

17. Regarding Malaysia's exports by product and destination, table 3 suggests that the United States is Malaysia's largest market for electrical machinery - the country's most dynamic export item over the last few years - and wooden furniture (in the 1970s, by contrast, the United States mainly imported raw materials from Malaysia. The European Union (rubber, cocoa, sawn timber) and Japan (crude petroleum, pineapple, sawn timber and tin) are important export destinations of raw materials from Malaysia; exports to the ASEAN countries are more diversified, resembling more closely the overall export structure of Malaysia.

18. A comparison of tables 3 and 10 shows that the pattern of export destination corresponds closely to the sources of foreign investment in Malaysia, in particular with respect to the manufacturing sector. This supports the observation made earlier that the value-added of manufacturing is low and linkages between production in free trade zones (FTZs) and the rest of the economy are weak; it also suggests that foreign investors import intermediate goods from their parent or associate companies in their home countries, and export the processed products back either to their country of origin or to other markets.

Chapter II

Economic policy environment

A. General economic policy environment[5]

1. Introduction

19. With a per capita income of about US$ 2,800 in 1992, manufacturing accounting for 25 per cent of GNP, and manufactured goods representing almost half of its total exports, Malaysia is an upper-middle-income, second-generation newly industrializing country. Malaysia has a rich natural resource base, including oil and gas; it is among the world's leading producers and exporters of a number of primary commodities, including cocoa, palm oil, rubber, tin and tropical hardwood. The Malaysian economy has undergone important structural changes since the early 1980s when the Government embarked upon an ambitious development strategy and substantially increased public-sector investment in construction-related infrastructure and heavy manufacturing industries such as automobiles, cement, iron and steel. The agricultural sector has, nonetheless, remained one of the major dynamic forces in the Malaysian economy, with first palm-oil, and then the cocoa and wood sectors being the economic areas expanding fastest.

20. Since the beginning of the 1970s, government policies have been directed towards social objectives to be attained in parallel with economic growth; the Government has pursued a policy of "shared growth", which has been employed by all Governments of East-Asian countries in one form or another, in order to ensure maximum public support for policies. Although the Government has sized down the importance attached to numerically-specified equity considerations during the 1980s, explicit wealth-sharing programmes have continued to be a centre-piece of economic policy.

21. The Government's attitude towards policy intervention in the economy has undergone substantial changes over the past few decades. During the 1960s, the Government concentrated on the provision of basic services, while at the beginning of the 1970s, a shift took place towards greater and more direct participation across most economic sectors, culminating in a strategy of industrial transformation on the basis of large-scale public investment during the first half of the 1980s. The unsustainable budget and current-account deficits which were a direct consequence of this industrialization strategy triggered another policy change in the late-1980s, characterized by the greater role played by the private sector in promoting development. This policy change has redefined, but not necessarily reduced, the Government's role in the economy. Since this change, Government activities have been focused on a limited number of strategic activities complementary to private-sector investments. These activities have included investment in infrastructure, promotion of human capital development and the encouragement of technological progress. In addition, the Government has relaxed controls, including those on foreign direct investment, with a view to deregulating and liberalizing the economy. Regarding the trade policy regime, following a phase of import substitution during the 1960s, the development strategy in Malaysia during the 1970s and early-1980s combined import substitution with export promotion, in

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[5] See table 4 for main economic indicators of the Malaysian economy.

Table 4: Main economic indicators of the Malaysian economy, 1970-1993

	1970	1975	1978	1980	1982	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GNP (millon ringgit)	11,800	21,605	36,186	51,390	59,690	74,182	72,039	66,814	74,679	85,777	96,684	110,764	123,548	140,267	157,925
GDP growth rates(per cent)	-11.2	0.8	6.7	7.4	5.9	7.8	-1.1	1.1	5.4	8.9	9.2	9.7	8.7	7.8	8.4
Exports fob (million ringgit)	5,163	9,231	17,074	28,172	28,108	38,647	38,017	35,319	45,225	55,260	67,824	79,647	94,497	103,657	121,359
Export value index (1980=100)	18	33	61	100	100	137	135	125	161	196	241	283	335	368	431
Export / GNP ratio (per cent)	44	43	47	55	47	52	53	53	61	64	70	72	76	74	77
Imports cif (million ringgit)	4,288	8,530	13,646	23,451	29,023	32,926	30,438	27,921	31,934	43,293	60,858	79,119	100,831	101,441	117,422
Import value index (1980=100)	18	36	58	100	124	140	130	119	136	185	260	337	430	433	501
Import / GNP ratio (per cent)	36	39	38	46	49	44	42	42	43	50	63	71	82	72	74
Fiscal balance (million ringgit)	-458	-1,892	-2,896	-7,104	-11,171	-7,075	-5,708	-7,506	-6,153	-3,891	-5,260	-5,515	-5,640	-6,242	-8,646
Fiscal deficit (per cent of GNP)	4	9	8	14	19	10	8	11	8	5	5	5	5	4	5
Gov. expenditure (million ringgit)	2,728	6,166	10,439	18,971	23,751	24,085	23,902	24,444	23,379	25,207	30,838	36,264	39,812	45,711	50,209
Consumer price inflation (per cent)	1.8	4.4	4.9	6.7	5.8	4.0	0.3	0.7	0.3	2.6	2.7	2.7	4.4	4.7	3.6
Deposit interest rate (per cent)	n.a.	n.a.	5.0	6.0	6.5	7.5	6.0	6.0	3.5	3.5	3.5	3.5	3.3	3.3	3.3
Lending interest rate (per cent)	n.a.	n.a.	9.4	10.2	12.3	12.8	12.1	12.0	9.7	9.0	8.7	9.0	9.7	10.3	n.a.
Savings as percent of GDP	22.4	22.3	27.3	29.1	23.8	28.5	25.5	25.3	31.0	30.9	29.0	29.1	26.5	30.5	33.4
Investment as percent of GDP	20.3	25.5	26.7	30.4	37.3	33.6	27.6	26.0	23.2	26.0	28.8	32.3	35.7	n.a.	n.a.
FDI (US$ million)	94	350	500	934	1,397	797	695	489	423	719	1,668	2,332	3,998	4,469	4,351
FDI index (1980=100)	10	37	54	100	150	85	74	52	45	77	179	250	428	478	466
Debt service (per cent)	n.a.	4.9	9.7	3.4	8.8	11.9	30.4	21.2	19.6	17.6	12.6	8.6	6.6	6.6	n.a.

Sources: All data from International Monetary Fund, International Financial Statistics, Yearbook 1994, except for data on debt service payments, which are from UNCTAD, Handbook of International Trade and Development Statistics, on GDP growth and savings rate, which are from World Bank, and on interest rates, which are from Bank Negara (1994, pp.562-563).

relatively labour-intensive sectors. Since the mid-1980s, the economy has been increasingly liberalized and deregulated. In short, direct state intervention has been present but less pronounced than in many other developing countries and was largely abandoned when it started to threaten macroeconomic stability.

2. The NEP and direct government support

22. Malaysia is an ethnically mixed society with about 60 per cent of the population being "Bumiputras", i.e., Malays and other indigenous groups, 30 per cent Chinese, and the remainder largely Indian. With independence from the United Kingdom in 1957, the country inherited substantial discrepancies in income distribution between the ethnic communities, with the Bumiputras being disproportionably affected by poverty. Differences in household income were exacerbated during the 1960s, as a result of the skewed pattern of regional dispersion of higher valued-added activities. All the industrial estates established during the 1960s had been concentrated around urban areas which already tended to have higher than average income levels. This geographical concentration of economic activities, which generated relatively higher household income, seems to have been a response mainly to the manner the Government granted tax holidays under the Pioneer Industries Ordinance of 1958 and how it carried out investment in communication networks, roads and highways.

23. The ethnic riots of 13 May 1969 marked an important change in the economic policy environment in Malaysia. Prior to these events, development planning was somewhat indirect, macro-oriented and based on the assumption that economic gains achieved in one part of the economy and by one segment of the population would automatically permeate into the economic system and hence benefit disadvantaged groups of the Malaysian society as well.

24. After 1969, by contrast, development planning became more positive and direct, putting increased stress on social concerns. At the same time, the Government abandoned its policy emphasis on import substitution, followed from independence to the late 1960s, by adding elements of an export-promotion strategy to the adopted trade policy regime. This approach has been implemented through policy frameworks and a series of strategic five-year plans. Between 1970 and 1990, general government policies were guided and governed by the New Economic Policy (NEP) which has accorded highest priority to eradicating poverty and reducing the ethnic imbalances in income, employment and ownership of assets, i.e., aimed at eliminating the identification of race with economic function (Bumiputras: agricultural sector; Indian: workers on plantations and in manufacturing and engaged in business; and Chinese: administrative and managerial categories, particularly business). In this context, an ownership restructuring target was established in 1973; it prescribed a "30:40:30" per cent proportionate distribution regarding corporate wealth owned by Bumiputras, other Malaysians and overseas investors, respectively, by 1990. In addition to providing increased ownership to Bumiputras, this target implied above all a sizable reduction in equity ownership by foreigners.

Box 1
Pineapples

Malaysia has produced and exported pineapples since before Independence. The NEP gave new impetus to these activities in those areas where soil quality did not allow for palm oil plantations. In the state of Johore with its abundant availability of peat soil suitable for pineapple but not for oil palm trees, the NEP's objective of eradicating poverty in rural areas has therefore been based on pineapple cultivation rather than palm oil production. To this effect, smallholders who plant pineapple as a monocrop or as an intercrop with coconut have been eligible for a replanting grant in the form of materials, fertilizer and other farm assistance as well as cash assistance to cover labour costs. In addition, pineapple farmers have been able to purchase fertilizer at half the market price from appointed stockists. Pineapple production has played an important role in the socioeconomic development of Johore; it has helped establish supporting economic activities in canning, packaging and transportation, in addition to the direct provision of employment. Estates account for about 60 per cent of total production with the remainder being produced by smallholders. The three canneries presently processing pineapple are privately owned. The Malaysian Pineapple Industry Board determines the price of fresh fruit delivered to the canneries in consultation with canners and growers. Export marketing is done by the canneries themselves.

Table 5: Production and export of pineapple, 1970-1993

Year	Production		Export of canned pineapple	
	Fresh fruit (tons)	Canned pineapple (tons)	Volume (tons)	Value (RM mn)
1970	313,407	69,369	65,817	51.8
1975	215,243	39,421	41,689	53.8
1980	185,273	41,927	36,022	51.0
1985	152,547	44,292	34,124	55.1
1987	148,092	43,786	41,243	50.6
1989	179,599	48,170	42,606	63.0
1990	168,275	44,568	49,285	79.5
1991	189,679	52,044	49,317	94.5
1992	189,344	48,161	43,124	80.7
1993	161,130	42,119	44,739	69.5

Source: Ministry of Primary Industries (1988b, p. 147; 1994b, p. 115)

Table 5 suggests that Malaysia has not been able to expand exports of canned pineapples on a sustainable basis in recent years. The relatively poor development of pineapple exports is due to two main factors, namely a shortage of fresh fruit supply and market access problems. The supply of fresh fruit has been constrained because production has been limited to the state of Johore - a project designed to extend the plantation area to the state of Sarawak is in the planning stage - as well as to unsuccessful attempts to introduce high yielding varieties. The latter caused the fresh fruit supply to decline until the late 1980s when the pineapple planting system was changed. More recently, smallholder productivity has increased since the introduction of a new hybrid that allows for greater plant density. Owing to the supply constraint, the capacity of canneries has been under-utilized leading to problems in competitiveness on the world market. In addition, exporters from Malaysia face a tariff rate of 24 per cent and a GSP-quota rate of between 12 and 15 per cent on the market of the European Union [Ministry of Primary Industries (1994b, p. 122)] compared to the preferential treatment given to signatories of the Lomé Convention which have emerged as competitors in the market of the European Union, in particular Kenya and Swaziland [Chew (1994, p. 6)]. Such market access problems have spurred pineapple exporters from Malaysia to look for non-traditional markets in the Middle East. These markets could be penetrated as a consequence of market-promotion activities such as marketing missions. The steep increase of exports of canned pineapple to Japan over the last few years - as shown in table 3 - may be attributed to the fact that Japan abolished import quotas on pineapples in April 1990 and that Japanese importers frequently inspect the cleanliness and hygienic conditions of pineapple canning in Johore to ensure quality standards required on the Japanese market.

25. A policy of giving special support to the economically disadvantaged parts of the population as well as to agricultural development - "the twin aims of poverty alleviation and restructuring society" - was a logical consequence of the objective to eradicate poverty, given that in 1973 about 47 per cent of the population in Peninsular Malaysia lived below the poverty line, that poor households were predominantly Bumiputras dwelling usually in rural areas (44.8 per cent of poor households lived in rural areas compared to 21.8 per cent in urban areas), and that educational achievement and asset ownership were, in general, lower for Bumiputras than for Indians and Chinese. The strategy adopted was to tackle rural poverty by increasing the active participation of poor rural households in an *expanding* national "cake" rather than to displace disadvantaged parts of the population and to *re-distribute* existing wealth. Rural development therefore faced two inter-related hurdles: first, improving rural employment opportunities by increasing opportunities for higher income earning capacities of rural households, and secondly, improving agricultural production by the promotion of production and export of primary commodities, such as rubber, palm oil, cocoa and pepper. This strategy has entailed land use designed to give a means of production to previously landless farmers; large-scale infrastructural development such as irrigation and transport projects; and improved access of farmers to central agricultural institutions which provide support services for marketing, credit taking and fertilizer employment. An important element of the Government's policy, in tackling rural poverty and supporting development of the agricultural sector, has been to use the increasing returns from crude petroleum exports to raise the incomes of small-holder farmers, either directly, through income subsidies, or indirectly, through a reduction in the export tax levied on their crops.

26. Other important activities carried out by the State in this regard have included the management of enterprises; training by these enterprises has been provided to Bumiputras with a view to letting them eventually take over management activities. Specialized agencies have been established in order to provide technical and consultancy services as well as public investment funds to Bumiputera enterprises. The operation of a quota system in the allocation of bank credits has provided preferential access to Bumiputera-owned companies. The overall objective of these activities is development of a Bumiputera commercial and industrial community. By 1990, the incidence of poverty had in fact declined, to about 20 per cent of households (15 per cent of poor households lived in rural areas compared to 4.5 per cent in urban areas). In addition, ethnic differences in income distribution, asset ownership and years of schooling are being alleviated [data from World Bank (1993a, p. 307)]. Regarding equity ownership, the share held by foreigners fell from 63.3 per cent in 1970 to 25.1 per cent in 1990, thus more than fulfilling the NEP target, while that of non-Bumiputra Malaysians rose to 46.2 per cent, i.e., also exceeding the target, while equity ownership of Bumiputras increased to only

20.3 per cent, far short of the targeted level of 30 per cent [Government of Malaysia (1991, p. 12)].

27. Within the framework of the NEP, the National Agricultural Policy (NAP) has governed overall policies for the agricultural, forestry and fisheries sectors. The NAP was adopted in 1976, then reformulated in 1984, against the background of economic growth limited to a few urban areas along the west coast of peninsular Malaysia, while a large part of the population lived in rural areas. The main objective of the NAP, therefore, was new land development, with a view to creating new employment opportunities, raising the level of food

Box 2
Ducks rather than tin

The role of tin, which used to be a mainstay of the Malaysian economy has gradually declined over the years. The recent setback was market-driven and mainly due to the breakdown of the price support of the International Tin Council and the collapse of the tin market in October 1985. By contrast, the gradual loss of significance of tin for the Malaysian economy before 1985 was the consequence of a deliberate strategy by the Government, pursued within the framework of the NEP, to support the development of a renewable resource in rural areas, namely palm oil, at the expense of the depletable resource tin, mined in urban areas. Table 6 shows that the number of mines has declined drastically over the past few years in response to this policy. Abandoned mining land has been used for agriculture and aquaculture, such as duck farming, to provide alternative employment opportunities to laid-off mine workers.

Table 6: Basic statistics on tin, 1970-1993

Year	Production (tons)	Import (tons)	Export (tons)	Average price (RM/kg)	Number of mines	Employment
1970	73,795	13,726	92,631	10.99	1,083	49,453
1975	64,364	18,476	77,940	15.94	910	39,736
1980	61,404	8,422	69,498	35.72	852	39,009
1985	36,884	7,423	57,400	26.67	279	16,829
1987	30,388	17,728	49,612	16.84	221	10,964
1989	32,034	23,857	49,480	23.09	255	12,695
1990	28,468	21,732	52,703	16.45	141	8,508
1991	20,710	30,536	42,425	15.05	92	6,594
1992	14,339	33,264	45,149	15.25	63	4,672
1993	10,384	27,277	35,545	13.09	43	2,296

Source: Ministry of Primary Industries (1988b, p. 216; 1994b, p. 178).

Despite the declining importance of the tin sector in general, Malaysia has developed three downstream tin-based industries - producing solder, tinplate and pewter - which have absorbed about 5 per cent of the country's tin production. The former two sectors started large-scale operation in 1983, while the latter has been in existence for many years. The solder and pewter industries produce mainly for export, while the main part of the tinplate output is used domestically in can-making. The total value-added of these downstream activities has, however, been negligible compared to that of smelting activities. Regarding further downstream activities, successful domestic research efforts in the development of organtins, which are used as stabilizers in polyvinyl chloride (PVC), provided the basis for the acquisition of a chemical factory in Germany in 1992 which produces organtin compounds. This acquisition may help commercialize domestically developed, patented know-how in the tin chemicals business.

production, and achieving a wider and more effective representation and participation of the Bumiputra community in modern and commercial agriculture, agribusiness and agricultural trade. This strategy was facilitated by a population that was relatively small and the availability of ample new undeveloped land; Malaysia was therefore able to avoid equity problems common to other developing countries with highly uneven land distribution.

28. New land development has, however, been constrained by (a) the need for maintaining farm holdings of a viable size in order to keep pace with the productivity of industry, as well as by (b) limits in the supply of cultivable land in peninsular Malaysia. The Government has, therefore, concomitantly aimed at rehabilitation and development of abandoned agricultural land through planting with improved planting materials and higher value crops, with a view to increasing productivity. The NAP has further emphasized increases in land productivity through the intensification of land use by promoting insitu development, that is double cropping, intercropping, livestock rearing, and the cultivation of higher value-added crops. These measures have allowed for an increase of labour productivity in agriculture by 3.6 per annum during the 1980s; nevertheless the productivity increase in agriculture was only half that achieved in the manufacturing sector during the same period [Ministry of Agriculture (1993, p. 9)]. The strategies adopted under the NAP have facilitated diversification in agriculture in terms of crops and activities as well as an absolute increase of earnings for the sector. However, the strategies have had an only limited impact on increases in farm income relative to increases in income from manufacturing. Consequently, with the new NAP (see below), the Government has shifted the emphasis from new land development to insitu development and productivity improvements.

3. Development planning and indirect government support since the mid-1980s

29. The Government has adjusted both the policy framework and the guidelines for sectoral policy to the changing domestic and international economic environment by adopting the Industrial Master Plan (1986-1995), the Second Outline Perspective Plan (1991-2000) and the new NAP (1992-2010). The overall objective of the new development policy has been to attain balanced national development in terms of economic sectors, regions and social factors - based on the principle of growth with equity, with a view to becoming a fully developed nation by the year 2020 ("vision 2020"). The main characteristics of the concomitant policy adjustments are (a) identification of the private sector to take the leading role and provide dynamism in the development process, while the Government will create a favourable climate for private investment by expanding the public sector programmes for human resources development and upgrading of infrastructure facilities; and (b) the equity objective is no longer pursued through the achievement of specific numerical targets, associating equity ownership with wealth, but through increasing the capacity of the Bumiputra community to create wealth and manage it, including the perseverance in changes of attitudes and their value system, with a view to ingraining fully the business culture of entrepreneurship and risk-taking among the Bumiputra business community [Government of Malaysia (1991, p. 8)].

30. Redirecting the economic policy stance from direct to indirect government support was first reflected in the Industrial Master Plan (1986-1995) (IMP). The Plan had been elaborated by the Malaysian Government in cooperation with UNIDO as 'an indicative Plan outlining policy directions and priorities

towards utilizing the country's natural resources and accelerating growth in the manufacturing sector in order to facilitate growth as well as the redistributive aims of the NEP" [UNIDO (1991, p. 53)]. One of the Plan's recommendations was to adopt a resource-based manufacturing strategy, with a view to maximizing economic benefits in terms of growth, trade balance and sectoral linkages.[6] Accordingly, subsector-specific industrial policies have been adopted in 12 priority economic sectors, of which seven are resource-based (including rubber products, palm-oil products, food processing, wood-based industries, chemical and petrochemical industries, non-ferrous metal products, and non-metallic mineral products) and five are non-resource-based (including electronics and electrical machinery, transport equipment, machinery and engineering industries, iron and steel, and textiles and apparel). Sectors considered "priority" have been those expected to contribute to Malaysia's industrial development - in particular with respect to employment and income generation, foreign-exchange saving through import substitution, value-added creation as well as their linkages with other sectors of the Malaysian economy - and where the country's comparative advantage was strongest in international trade. According to the general outward-oriented industrialization approach, the "IMP advocated, *inter alia*, incentives for import substitution and elimination of discrimination against exports. The IMP also argues the case for a freer trade regime, keeping the infant industry considerations to the minimum. In view of the development rationale and constraints, the IMP entails 'selectivity' in promoting heavy industries, which need to be strategically selected to lay the solid formation for more balanced growth, enabling Malaysia to leap frog to an advanced industrial society by the turn of the century" [ibid].

31. The Government has further committed itself to reduce direct interventions in the economy and increase reliance on market forces in the Second Outline Perspective Plan (1991-2000). The main objective of the Plan is to enhance diversification and to increase growth in higher value-added indigenous activities with widespread linkages across sectors. As the Plan states, "the elimination of sectoral distortions that had led to artificially higher returns in the protected industrial sector relative to agriculture, will require a review of the protection policies to promote the development of selected industries that have greater backward linkages to agriculture" [Government of Malaysia (1991, p. 137)].

32. The new NAP (1992-2010) has been "based on the objective of creating a market-led, commercialized, efficient, competitive and dynamic agricultural sector in the context of sustainable development" [Government of Malaysia (1993, p. 21)]. The main differences in strategy with respect to the previous national agricultural policy include the focus(i) productivity improvements and <u>insitu</u> development rather than on new land opening and (ii) the "integration of agriculture ... with manufacturing to provide synergetic stimulus to output and income growth of both sectors" [<u>ibid</u>.], that is, an emphasis on agro-based and downstream development. The measures adopted to attain these objectives include: the improvement of infrastructural and communication facilities, the intensification of research-and-development and human-resource-development activities in order to increase land and labour productivity as well as the intensity of land use. Productivity gains are to be the main source of growth in the agricultural sector; the new NAP has envisaged to achieve an annual growth in productivity by 3.1 per cent to be driven primarily by vegetable, fruit, fish and livestock production. Although the major part of this envisaged change in the pattern of agricultural production will result in import

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[6] For a calculation of intersectoral linkages, see Rahman (1991).

substitution, a further change in the export path of primary commodities can be expected to occur in the coming years.

Box 3

Fishery, horticulture and floriculture sectors

Given Malaysia's long coastline, it may be surprising that earnings from fishery exports have been negligible. In addition to exports of fresh fish, shrimps and prawns, two main export-oriented processing activities exist in the fishery sector, namely exports of frozen prawns and shrimps and exports of canned tuna fish. Since 1986, the latter two subsectors have been net contributors to the country's foreign-exchange earnings [Chew (1994, p. 4)]. Further development of the fishery sector has been constrained mainly by previous over-fishing in island and in-shore areas and by the absence of a trained, experienced deep-sea fishing community. The Government has therefore tried to intensify the dissemination of information, training of deep-sea fishermen and provision of adequate infrastructure, particularly in the form of fishing ports and marketing facilities as well as the gradual phasing out of the outmoded fishing fleet. Acquaculture - with a focus on prawns - has also been actively promoted under the National Agricultural Policy, for example, by including this sector on the list of sectors enjoying the incentives under the Promotion of Investments Act (1986). Natural resource systems such as mangroves, rivers, lakes and ex-mining pools are planned to be developed for aquaculture.

Other than pineapples, Malaysia has not been a net exporter of horticulture products despite the availability of both air-cargo space for the export of fresh produce and processing facilities. Processing activities in the fruit subsector, for example, include the canning of jackfruit, starfruit, guava and papaya, while those in the vegetable subsector include canning and pickling as well as the production of sauces and juices. The production of fruit and vegetable has, however, fallen short of demand which may be mainly a consequence of the shortage of labour in agriculture and the fact that it may be easier to do business in sectors such as palm oil with a well-established international trade network rather than start a business in the unfamiliar and highly competitive world market for horticulture. The objectives of the new NAP include the formulation of a long-term plan for fruit exports including market and sub-market targets for fresh and processed canned products, market research and promotion, as well as the development of a proper grading system.

33. The shift in strategy from new land development to land rehabilitation and productivity increases is also a result of problems encountered in the agricultural sector generated by the transformation towards an industrialized economy, namely labour shortages in rural areas and abandoned land. With productivity increases in manufacturing exceeding those in agriculture and the resulting relatively high wages in urban areas where manufacturing sites are located, rural youth, with vastly higher educational attainments compared to earlier generations, have shown reluctance to enter the labour market in agriculture. This in turn has led to upward pressure on wages for resident agricultural workers, as well as to an increasing inflow of semi-legal immigrant workers to the plantation sector. Given that wages in Indonesia - which has emerged as a major competitor for rubber, palm oil and cocoa exports - are well below those in Malaysia, the continuous upward pressure on wages is threatening to erode Malaysia's price competitiveness for those products in world markets unless cost increases can be offset (at least partly) by increases in labour productivity and the adoption of more productive technologies. A strategy to this end has been supported up attempts to develop off-farm activities for example by spreading out geographically the location of industrial estates to

areas within the reach of rural farm household members and by encouraging farmers to undertake off-farm activities such as handicrafts and other home-based, simple manufacturing activities with a view to raising the farmer's total household income, with the aim of arresting migration and allowing for investment in formal education by the farmer's family.

B. Trade policy orientation

34. Malaysia has pursued an infant-industry type import-substitution policy, albeit modest by international standards; it has been combined with an export promotion policy, in particular since the mid-1980s. "It is the policy of the government to provide tariff protection to deserving industries which are in a position to supply a major portion of the domestic market demand, provided that the product is of acceptable quality and the price to consumers in reasonable. The objective of granting protection is to enable such newly-established industries to compete on an equal footing with imports in the initial stages. In the granting of tariff protection, consideration will be given to the degree of utilisation of domestic raw materials, the ... local value-added to be achieved and the technology level of the industry and the spin-off effects on the economy" [MITI (1993, p. 155)]. Following this general strategy, the Government has established a system of relatively low nominal tariffs but high and widely varying effective rates of protection, constituting a tariff system "tailor-made" for the country's industrialization strategy. This industrialization strategy has worked at the expense of agriculture. "The active and fairly wide use since the 1970s of trade related (border) measures and fiscal incentives, part and parcel of the policy intervention package ... for industrial development placed the agricultural sector at a disadvantage" [Ministry of Agriculture (1993, p. 33)]. However, since the mid-1980s the anti-export bias has been offset by a change in the exchange-rate policy and by a review of fiscal and financial incentives. At the same time, the economy has become increasingly outward-oriented and international owing to deregulation and decontrol.

35. The first change in trade-policy orientation from import substitution alone towards a combination of import substitution and export promotion occurred in the early 1970s. The Free Trade Zone Act of 1971, establishing Free Trade Zones (FTZs), provided several incentives for companies by: exempting the import of raw materials and capital equipment from customs duty and sales tax; reducing customs documentation requirements; and giving partial relief from company income taxes and additional excess profit taxes, with a view to providing facilities for manufacturing industries that produce mainly for export. In addition, the Government helped provide infrastructure similar to that in industrial estates, i.e., cheap land, water and electricity supply. Licensed Manufacturing Warehouses (LMWs), which differ from FTZs basically in their juridical status, were first introduced in 1967 with a similar objective but in locations where the establishment of FTZs was deemed neither practical or desirable. The Free Trade Zone Act of 1971 has been replaced by the Free Zones Act of 1990, extending the benefits enjoyed by companies engaged in manufacturing activities to commercial activities, which have been defined as trading, break bulk shipping, grading, packing, relabelling and transit. As a result, there are now two kinds of free zones, namely Free Commercial Zones for companies with commercial activities and Free Industrial Zones for manufacturing companies. At present there are 11 free zones - mainly located around Kuala Lumpur and near the border with Singapore - with 136 companies operating in 1991, nearly three quarters being foreign owned, accounting for more than 90 per cent of total direct employment. Firms operating in LMWs have tended to be both

smaller and more labour-intensive than those in FTZs, as the former have been principally engaged in the manufacture of garments; the latter have mainly attracted companies in the electronics sector.

36. The outward-oriented development strategy initiated in the 1970s, characterized by the establishment of FTZs, shifted during the first half of the 1980s when the Government launched a second round of import substitution; this time, the focus was on the development of domestic industrial infrastructure, that is, chemicals, cement, aluminium, steel and transport equipment. Raising the degree of protection given to these sectors was part of the strategy, as evidenced by table 7.[7]

Table 7: Nominal and effective rates of protection, 1982, 1985 and 1987 (per cent)

Industrial classification	Nominal rate of protection (NRP)			Effective rate of protection (ERP)		
	1982	1985	1987	1982	1985	1987
Food manufacturing	2.65	6.18	4.67	4.55	13.87	9.17
Beverage	19.63	24.51	10.56	27.49	33.81	13.37
Tobacco	27.04	77.83	52.81	31.58	91.35	61.78
Textiles	13.62	9.44	5.44	29.16	17.36	7.91
Wearing apparel	20.13	19.70	13.26	39.99	44.54	40.15
Leather	19.52	22.52	19.53	64.21	73.65	58.50
Footwear	21.26	24.35	18.52	122.86	135.55	84.87
Wood and cork products	8.23	10.74	8.74	24.54	27.29	17.03
Furniture	36.21	32.65	18.23	83.39	71.72	37.18
Paper and paper products	2.37	4.81	4.21	1.98	5.39	4.28
Printing and publishing	2.78	3.65	2.64	3.55	3.30	1.33
Industrial chemicals	3.90	4.63	2.89	4.56	4.76	1.89
Other chemical products	4.22	4.30	3.05	4.81	3.36	1.66
Petroleum refineries	2.33	3.63	7.27	10.67	16.53	33.63
Rubber products	18.91	20.45	8.45	50.01	53.25	19.83
Plastic products	20.08	13.61	6.07	50.47	31.42	11.89
Pottery, china, glass	20.38	21.84	16.41	38.96	40.31	29.28
Nonmetal. mineral prod.	8.97	15.10	11.67	16.91	28.23	21.11
Iron and steel	5.72	4.12	3.09	24.62	10.73	2.18
Nonferrous metal	2.34	2.52	1.27	15.26	16.30	7.69
Fabricated metal prod.	5.53	11.40	6.57	8.19	24.21	12.81
General machinery	2.65	3.19	2.63	-0.45	-0.03	1.12
Electrical machinery	2.94	1.96	0.87	1.34	-1.15	-2.64
Transport equipment	5.89	13.87	4.21	5.66	15.30	4.16
Precision equip. & oth.	2.93	3.76	3.18	1.55	2.86	2.98
Standard deviation	9.43	15.52	10.51	29.14	32.32	21.88

Source: Okamoto (1994, p. 462)

[7] Note that cement is counted among non-metallic mineral products, while aluminium is part of fabricated metal products.

37. GATT secretariat calculations for 1991 [GATT (1993a, p. 120)], show the effective rates of protection[8] from tariffs and indirect taxes as negative for several natural-resource based products, such as forestry (-88.5%), rubber products (-24.8%), as well as apparel (-8.4%), but positive for a wide range of non-resource-based manufactured products, such as electrical machinery (11.5%) and textiles (50.7%). This means that the forestry and rubber sectors have been taxed relative, for example, to the electronics sector. It would therefore appear that the trade regime continues to be biased towards the promotion of non-resource-based manufactures.

38. Trade policy measures regarding exports comprise export taxes and licensing; there have been no direct export subsidies. Apart from ensuring adequate supply in the domestic market, the main rationale for export taxes seems to have been revenue collection and, in the cases of rubber and palm oil, producer price stabilization.[9] Taxes have been set at ad valorem rates on exports of a number of commodities. The progressive tax rates have been based on the amount by which the actual export price exceeds a so-called "trigger price" whereby the level of this trigger changes from time to time. Table 8 suggests that taxes on rubber and palm oil exports have, in general, led to some degree of stability, while, at times, they have introduced an additional degree of uncertainty into the predictability of producer prices. For example, producer prices for rubber fell by only 23 per cent between 1980 and 1982 while the export price fell by 39 per cent. Conversely, the tax rate declined slightly between 1979 and 1980 at a time when the export price of rubber rose. The table also suggests that the tax scheme, by employing progressive rates, has induced considerable instability in government revenues from this tax. This may render planning of government spending complicated and lead to a parallel development of export prices and government expenditures. The importance of export taxes as revenue for government finance has been declining over the past few years.[10] In response, export taxes have been gradually abolished. In 1994, there were export duties on petroleum products (25%), saw logs (5.4%), forestry (3.1%), fish products (2.5%), manufactures of animal feed (2.5%), and non-ferrous metals (3.2%). Forest products were not subject to export duties in the Eastern states of Sabah and Sarawak but these States levy royalties on logging. Previous export taxes on tin were abolished in 1990; those on rubber and pepper were abolished in 1991.[11]

39. Licenses have been required for the exports of several primary commodities, including cocoa, palm oil and rubber. The main objective of this has been to ensure that exports are of high quality. An export levy has been imposed on some species of sawn timber, with the objective of ensuring an adequate supply for the domestic wood-based industry, as well as financial funds for research and development; a levy on palm-oil production has been set with a view to funding palm-oil-related research. In addition, there has been a

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[8] The effective rate of protection is the percentage by which value added at domestic prices exceeds value added at world prices.

[9] For the stabilization of rubber producer prices, see Bautista and Gonzales (1992).

[10] Taxes on primary export commodities accounted for 4.3 to 6.7 per cent of the Government's total tax revenue in 1989 to 1992, compared with 18.4 per cent in 1980 [Bank Negara (1994, p. 9)].

[11] The major export taxes still in force are those on palm oil, cocoa and petroleum. See table 14 for the structure of the export duty on palm oil.

research-and-development cess on rubber production and exports. This system of funding research-and-development activities within selected sectors has allowed for continuous technological progress and an increase in productivity in these natural-resource-based sectors without placing a burden on the Government's budget. For more details, see the sections on individual commodities below.

Table 8: Taxes on rubber and palm oil exports from Malaysia, 1979-1986

	1979	1980	1981	1982	1983	1984	1985	1986
Rubber								
Export price (US$/kg)	1.00	1.36	1.11	0.83	1.06	0.93	0.77	0.80
Export tax rate (%)	24.9	23.7	14.0	4.1	7.5	4.4	0.1	0.0
Total tax receipts (US$ mn)	511	493	231	47	117	66	1	0
Palm oil								
Export price (US$/kg)	594	518	505	423	435	629	505	266
Export tax rate (%)	9.6	6.4	5.0	2.6	3.9	4.2	2.3	0.5
Total tax receipts (US$ mn)	2	75	63	32	50	80	38	7

Source: Knudsen and Nash (1990, p. 550)

C. Market access conditions

40. Table 9 shows that, in terms of non-tariff barriers (NTBs), Malaysia fares very well compared to other developing countries, except for goods subject to the Multi-Fiber Arrangement. The fact that Malaysia's trade pattern is dominated by primary commodities and electrical machinery, that is, items which usually face no or low NTBs, probably explains this result.

41. Regarding tariffs, Malaysia has enjoyed preferential access to markets in the European Union, the United States of America and Japan under the Generalized System of Preferences (GSP). In 1993, these three markets together accounted for more than 90 per cent of Malaysia's exports under the GSP, which totalled about RM 19 million, equivalent to 13.5 per cent of the country's total exports. The structure of exports under the GSP has changed considerably over the past ten years, from being predominantly the agricultural sector to manufactures, with electronics and electrical products alone accounting for almost one-third of total GSP exports. The relationship between the kind of goods produced, the overcoming of market access barriers, the market of export destination and the supply capacity in Malaysia's diversification experience is well illustrated by the fact that a large part of the production potential for electronics has been created through FDI from the United States: a substantial share of electronics produced in Malaysia is exported to the United States; these exports enjoy preferential market access under the GSP in the United States.[12]

[12] The most significant agricultural export item under the GSP in 1993 was palm oil and related products, accounting for 8 per cent, followed by rubber goods (6.7 per cent) and wood products (5.5. per cent) [MITI (1994, p. 39)].

Table 9: Frequency and trade coverage ratios of non-tariff barriers faced by exports from Malaysia in the European Union, Japan and the United States, percentages

Sector	Exporter	Market					
		European Union		Japan		United States	
		Frequency ratio	Trade coverage ratio	Frequency ratio	Trade coverage ratio	Frequency ratio	Trade coverage ratio
Food	Malaysia	18.9	3.6	52.3	29.7	4.2	2.4
	Developing countr.	30.7	27.5	51.2	56.3	4.6	10.6
	Developing Asia	31.7	31.7	49.4	58.8	4.0	14.0
	Indonesia	14.9	18.3	47.8	71.8	2.6	5.9
	Thailand	32.0	66.2	46.9	73.4	5.2	38.0
	Brazil	31.2	15.8	36.8	25.8	6.5	18.2
Agricultural raw materials	Malaysia	0.0	0.0	5.6	0.0	2.3	0.0
	Developing countr.	4.0	3.9	20.0	6.0	2.6	7.0
	Developing Asia	3.4	3.3	18.3	6.0	2.8	3.6
	Indonesia	1.2	0.0	17.2	1.8	2.1	0.0
	Thailand	1.2	0.0	17.2	2.5	3.2	0.1
	Brazil	4.3	1.3	22.4	3.5	1.2	0.0
Ores and metals	Malaysia	11.3	12.0	0.0	0.0	3.7	0.0
	Developing countr.	21.4	15.4	0.2	0.6	20.1	24.1
	Developing Asia	17.0	20.6	0.2	0.0	15.3	36.6
	Indonesia	24.0	43.8	0.0	0.0	0.0	0.0
	Thailand	11.5	0.6	0.0	0.0	8.8	65.3
	Brazil	44.5	17.3	0.0	0.0	51.2	45.8
Mineral fuels	Malaysia	0.0	0.0	13.3	1.4	20.0	0.0
	Developing countr.	18.2	33.0	9.0	2.4	6.2	4.4
	Developing Asia	19.4	29.1	9.3	2.4	6.6	2.6
	Indonesia	0.0	0.0	25.0	5.2	0.0	0.0
	Thailand	0.0	0.0	0.0	0.0	0.0	0.0
	Brazil	5.7	8.6	0.0	0.0	7.1	62.0
Textiles	Malaysia	97.2	99.7	0.0	0.0	90.0	99.2
	Developing countr.	76.8	78.6	2.4	7.3	61.4	75.7
	Developing Asia	80.0	78.7	2.7	7.5	74.7	78.9
	Indonesia	94.3	98.0	0.0	0.0	88.4	99.5
	Thailand	83.5	85.0	0.0	0.0	53.5	56.9
	Brazil	88.8	92.4	0.0	0.0	81.7	71.7
Apparel and clothing	Malaysia	86.5	69.7	0.0	0.0	93.3	75.1
	Developing countr.	69.3	76.7	0.0	0.0	57.4	84.3
	Developing Asia	77.6	80.6	0.0	0.0	77.3	88.3
	Indonesia	90.5	98.5	0.0	0.0	89.7	97.8
	Thailand	83.1	90.1	0.0	0.0	73.4	88.1
	Brazil	84.2	89.1	0.0	0.0	89.2	94.8
Manufactures (excl. chem.)	Malaysia	34.8	21.9	0.2	1.6	25.8	12.1
	Developing countr.	28.1	36.9	1.2	1.2	19.5	25.1
	Developing Asia	30.9	38.5	1.1	1.2	24.8	29.1
	Indonesia	53.1	49.9	0.9	0.0	34.5	52.9
	Thailand	38.7	47.6	0.7	0.2	19.6	15.6
	Brazil	26.6	28.1	2.1	0.3	17.7	9.3
All sectors	Malaysia	29.3	10.7	8.2	2.3	21.6	10.2
	Developing countr.	25.7	29.9	9.8	10.1	15.9	18.9
	Developing Asia	28.4	33.2	8.2	9.5	20.2	24.7
	Indonesia	42.2	27.1	10.4	9.0	26.7	18.9
	Thailand	35.4	52.9	10.3	32.1	15.7	19.8
	Brazil	25.0	17.9	9.2	7.2	18.3	20.1

Source: UNCTAD Data Base on Trade Control Measures.

Notes: (1) The broad group of NTBs used includes tariff quotas, increased tariffs, anti-dumping and countervailing actions, variable levies, quantitative restrictions, the surveillance of quantities and/or prices of imports, and various types of licensing. Health and safety regulations, technical standards and excise taxes are excluded. While data on NTBs pertain to 1990, trade data employed to calculate frequency and coverage ratios are those of 1988 for Japan and the European Union, and those of 1989 for the United States.
(2) Sectors are defined in SITC as the following: Food = SITC 0+1+22+4; agricultural raw materials = SITC 2 less (22+27+28); ore and metals = SITC 27+28+67+68; mineral fuels = SITC 3; manufactures excluding chemicals = SITC 6 to 8 less (67+68); all sectors = SITC 0 - 9.
(3) The frequency ratio gives the number of trade flows covered by NTBs as a share of the total number of trade flows, where the number of trade flows is the number of national tariff lines.
(4) The trade coverage ratio measures the value of imports affected by selected NTBs as a share of all imports.
(5) Figures for the European Union include country-specific measures in addition to common EU-measures.
(6) Developing countr. = all developing countries including China.

42. Furthermore Malaysian exporters have sought to overcome existing market access barriers by investing overseas. The Government has encouraged these activities by according favourable tax treatment to such investment, provided that a project (a) is undertaken to overcome market access barriers and utilize Malaysian raw materials; or (b) supplies inputs required by domestic industry; or (c) contributes to South-South cooperation [MITI (1994, p. 239)]. Incentives have been given mainly to investment in China, Cambodia, Chile and Viet Nam, emphasizing the manufacturing, mining and automotive sectors but also benefiting investment in palm oil refineries.

43. The relatively low incidence of NTBs and the share of exports enjoying preferential market access under the GSP could lead the reader to conclude that export diversification in Malaysia was facilitated by favourable market access conditions. However, it may also be argued that Malaysia deliberately diversified into commodities for which it was not facing market access barriers, with the result that these constraints had in fact a major impact on the structure of the country's export pattern. Considering the country's overall economic policy strategy, the latter interpretation seems more convincing. As Page (1994, pp. 154-155) has put it: "Malaysia offers an example of a country for which growth, exports, employment, and (at least at some period) the distribution of income among domestic groups have been the central objectives. How the exports or investment needed for this were achieved has been of secondary importance. Concerns about constraints met practical solutions as problems to be overcome, not avoided or negotiated away, and with little attention to consideration like foreign control. Malaysia would have increased its exports more rapidly, and probably with a different composition, had it not been faced with its existing barriers."

D. Investment policy

44. The Malaysian economy has enjoyed a high investment-GDP ratio, fluctuating in the range of 20 to 40 per cent over the past two decades. Evidence seen in table 4 suggests that these substantial fluctuations have coincided with changes in government policies (outlined in chapter II A). For example, the ratio rose by over 10 per cent in the early 1980s when the Government increased investment expenditure to build up heavy industry before dropping back to its level of the 1970s when this policy was abandoned in the mid-1980s. A second substantial rise in investment has occurred since the late 1980s, this time driven by foreign direct investment. This was probably in response to the change in investment incentives and foreign equity regulations following the 1985/86 economic crisis. Foreign direct investment has played an important role in the development of processed exports from the rubber and cocoa sectors - as will be discussed in detail below - in addition to those from the electronics sector.

45. The investment policy of the Malaysian Government has been based on several factors: (a) equity regulations, which favour indigenous Malays, and loan schemes with a concessionary element for Bumiputera companies in line with NEP-objectives; (b) Government investment in infrastructure as a complement to private investment throughout the past three decades, and massive direct investment in industrial projects during the early 1980s; (c) investment incentives characterized by tax incentives and the absence of high tariffs on imported capital goods; and (d) the successful attraction of foreign direct investment.

1. Equity regulations

46. Among the measures taken to implement the ownership restructuring policies of the NEP were government-sponsored take-overs of foreign companies[13] and the controversial Investment Coalition Act (1975). The latter empowered the Ministry of Trade and Industry to impose any condition before a license was issued or renewed "to ensure the 30 per cent Bumiputra equity participation in accordance with the NEP, on projects involving shareholders' funds of M$ 2.5 million and above or employing at least 75 full-time workers" [Ariff (1991a, p. 102)]. In addition, the Companies (Amendment) Bill 1984 included relatively restrictive amendments to the Companies Act 1965, in order to enforce compliance with equity rules. For example, the amendments provided for the establishment of a panel to administer, supervise and control take-overs and mergers, and required companies to disclose shareholdings of 5 per cent or more, in order to effect the relevant authorities' surveillance of predatory moves.

47. Some of the stringent NEP-equity rules, especially those concerning foreign equity, have been relaxed in recent years for two main reasons. The unsustainable level of external debt which had accumulated during the early 1980s created the need for capital inflows. In addition, figures published in 1985 suggested that the proportion of foreign equity had dropped to below the 30-per-cent target set by the NEP as a goal for 1990. Conditions for foreign ownership were therefore relaxed in 1986; most importantly, 100 per cent foreign ownership of capital was allowed. Foreigners have been allowed to hold 100 per cent equity if the company exports at least 80 per cent of its output; companies exporting 51 to 79 per cent of their production have been allowed full foreign equity ownership if the investor invests at least RM 50 million or implements projects which have at least 50 per cent value-added, and whose output does not compete with products fabricated domestically for the home market. The level of foreign equity participation for other projects can be up to 79 per cent if between 51 and 79 per cent of production is exported; between 30 and 51 per cent foreign equity has been permitted for projects exporting 20-50 per cent of their production; 51 per cent foreign ownership has been allowed for projects producing high-technology or priority products; and full foreign ownership has been allowed for projects which involve extraction or mining and processing of mineral ores. The level of foreign equity participation permitted usually depends on factors such as the level of technology, size of investment, value-added, location, and utilization of local raw materials and components [Ministry of Finance (1994, p. 155)]. Since 1988, 100% foreign equity participation has also been permitted for projects catering to the domestic market if the foreign investor is unable to find suitable local partners for the project. However, after five years from the date of operation, the foreign equity must be reduced in accordance with existing guidelines on foreign ownership based on the level of exports.[14]

2. Investment by the Government

48. The provision of adequate infrastructure has been one of the Government's key strategies to attain growth and diversification in the economy as well as to promote the participation of rural households in the growth process. Apart from expanding the physical supply of infrastructural facilities, the Government

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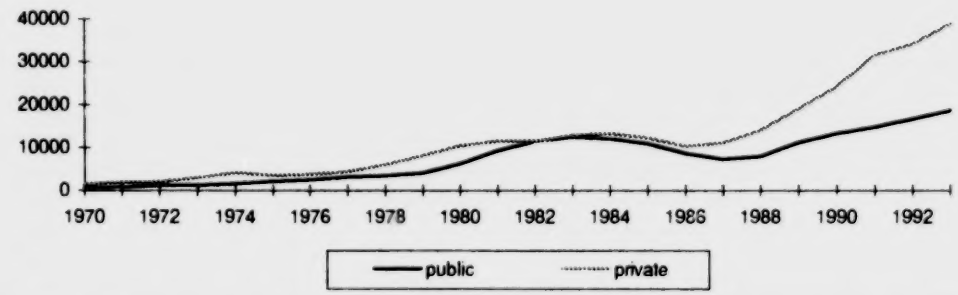
[13] See section B of chapter III, for the implementation of this policy in the case of palm oil.

[14] For details, see Malaysian Industrial Digest, Oct.-Dec. 1988, p. 2.

has emphasized quality and safety aspects of transport and communication facilities. With the need to finance and expedite the implementation of large infrastructure and utilities projects, privatization efforts have been accelerated in the early 1990s to complement the efforts of the Government. The private sector has been involved predominantly in projects concerning roads and highways, electricity, sewerage and water, with the Government managing the projects until they had reached a certain level of performance, giving it over to private hands when the need for expansion arose.

49. Direct public investments in heavy industry (e.g., automotive sector, cement, steel, etc.) were among the Government's main instruments during the early 1980s, in order to achieve the combined objectives of increasing the level of income and participation in manufacturing and commercial activities of indigenous Malays, on the one hand and of enhancing economic growth and diversification, on the other. However, the high level of expenditure associated with this strategy - see figure 3 for evidence on the relative share of private and public sources of total investment - placed a strain on the financial situation of the Government, resulting in a widening of the public sector's overall budgetary deficit. The Government therefore reduced public expenditure both by emphasizing greater management efficiency and financial prudence and by encouraging the private sector to play a greater role in the development process.

Figure 3: Private and public investment, 1970-1993, nominal values, RM mn



Source: Ministry of Finance

3. Investment incentives

50. Malaysia has offered a wide range of incentives to both domestic and foreign investors. Many effective incentives were introduced with the Incomes Tax Act, 1967, and the Promotion of Investment Act, 1986. However, the manufacturing sector has enjoyed these incentives for a long time, while incentives for agriculture were introduced only in 1986; the latter incentives are deemed "still inadequate to offset the fiscal incentive edge provided to the

are deemed "still inadequate to offset the fiscal incentive edge provided to the manufacturing sector" [Ministry of Agriculture (1993, p. 3)].[15] Since 1990, the Government has granted pioneer status and the investment tax allowance to small and medium-sized enterprises (SMEs).[16] Additional measures taken by the Government in 1990 to promote the development of SMEs included the creation of an Industrial Technical Assistance Fund.[17]

51. Investment and export incentives have mostly relied on tax incentives to encourage competitiveness in the private sector. Recently, however, the Government has taken steps to complement this strategy by encouraging investment more selectively, focusing on high technology, higher capital intensity and domestic value added, expanded linkages with domestic firms, and environmental protection. This means that in a longer term perspective, the thrust of investment incentives is likely to turn, favouring non-fiscal incentives, including the development of infrastructure, improving training facilities for skilled manpower, and liberalizing guidelines governing the inflow of skilled foreign labour, know-how, and equity capital.

4. Policy regarding foreign direct investment

52. Foreign direct investment (FDI) has played a very important role in the diversification of Malaysia's economy, in particular over the past 10 years. As Ariff (1991a, p. 132) points out: "Malaysia could not have initiated its industrialization programme without foreign participation, as it lacked the industrial technology, know-how and experience, and managerial expertise at the time of Independence. Over the years, Malaysia has acquired some of these essential ingredients."[18]

53. The market orientation of foreign investment projects as well as their ownership structure, sectoral destination and source has been changing over the past few years.[19] During the 1960s, foreign investors were largely involved in import-substitution industries (such as food, beverages and tobacco, building materials, etc.), while with the growing unemployment problem at the beginning of the 1970s the country tried to attract FDI primarily in the export-oriented textile and electronics industries, in particular through the establishment of

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[15] For example, export-based manufacturing companies could enjoy very attractive tax abatement rates, while similar agricultural companies were entitled to only small benefits. In addition, manufacturing companies undertaking modernization and expansion of production capacity have enjoyed an investment allowance which has not been available for agricultural producers. See Appendix 1 for an overview of the available investment incentives.

[16] SMEs have also been able to take advantage of the Vendor Development Programme, which was adopted for the automotive and extended to the electronic and wood-based sub-sectors (see Text Box 4).

[17] For details see Malaysian Industrial Digest, July-September 1990, p. 3.

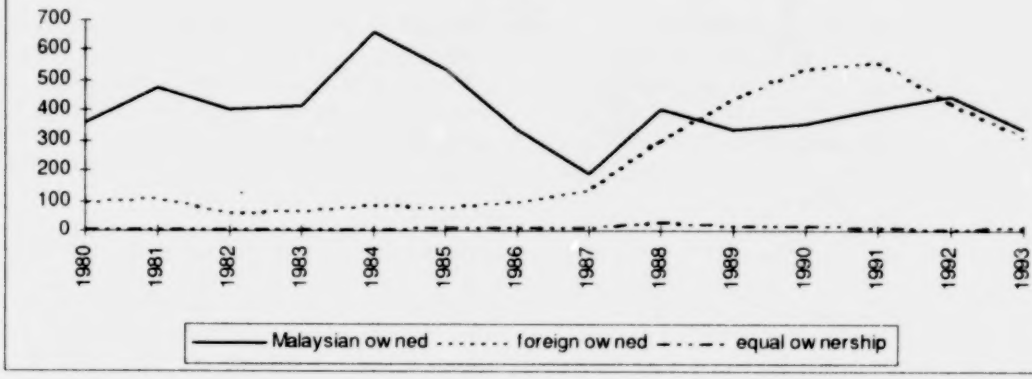
[18] Apart from getting access to advanced technology, managerial expertise and marketing know-how, the Government has sought to attract FDI in order to fill the savings-investment gap that had re-emerged at the beginning of the 1980s.

[19] Ariff (1991b) points out that recent foreign direct investment has also been characterized by a higher rate of capital intensity and a growing role of small- and medium-sized enterprises. The latter has allowed to disperse foreign direct investment geographically to the country's outer areas.

then increased significantly in the late 1980s, spurred by the possibility of retaining complete foreign ownership and by favourable external factors, in particular rising production costs in Japan and the NICs. The Government has tried to raise the 'quality' of FDI, promoting projects with high technology content[20], skill-intensity and linkages, through the implementation of specific guidelines for technology agreements between domestic and foreign counterparts, and the provision of protection for intellectual property rights.[21]

54. Figure 4 shows that the ownership structure of investment projects had changed considerably in the aftermath of the change in equity regulations in 1986, with the result that in the late 1980s and early 1990s foreign-owned projects accounted for a much larger part of capital investment than those with Malaysian ownership. Meanwhile, the number of FDI projects has fallen back to a more sustainable level.

Figure 4: Number of investment projects approved, by ownership, 1980-1993



Source: MITI (1994, p.249)

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[20] The extent of actual transfer of technology seems to have varied between different economic sectors. In the electronics sector, for example, transfer of technology seems to have been minimal. This sector has been dominated by a few subsidiaries of transnational corporations which have followed a policy of complete reliance on their parent company for all inputs and decisions regarding technology. Given the 'enclave' character of economic activities located in FTZs and the fact that training has been limited to on-the-job or in-plant training, technological spill-overs have been minimal. By contrast, learning effects seem to have been substantial. "It has been found that the level of sophistication in the local machine shop industry has increased as a result of the industry's contacts with electronics companies, while employees leaving the electronics factories have found the skills they had acquired useful in their new occupations" [Ariff (1991a, p. 128)].

[21] For details on these guidelines, see Ministry of Finance (1994, pp. 248-250).

55. The main sources of FDI have been Japan, Taiwan Province of China, and the United States of America, which jointly have accounted for more than half of total foreign direct investment over the past 10 years. Japan topped the list of most important sources of foreign investors until 1991 when it was overtaken first by the United States and then by Taiwan Province of China. Three phases of foreign direct investment can be distinguished: (a) investment in light manufacturing in the 1970s; (b) investment in the construction sector during the early 1980s; and (c) electronics-related investment since the beginning of the 1990s. The first two phases were dominated by giant corporations while smaller Japanese companies have played an important role in the third phase. Japanese companies produce a fairly wide range of manufactures of different technological levels, including radio cassette players, stereophonic equipment, television sets, etc. Two-thirds of FDI from the United States has been in the petroleum sector, but since 1988 the bulk of new investment has gone into the manufacturing sector, in particular the electronics industry. FDI from Taiwan Province of China, which was growing fastest after the change in ownership regulations in 1986, has gone mainly into electronics, textile and wood-based industries.[22] Foreign direct investment from Singapore has been more diversified going into a variety of products ranging from rubber products to electronics[23] [data from Ariff (1991a, pp. 109-122)].

56. Tables 10 and 11[24] show that FDI has been a dominant feature in export-oriented industries located in FTZs which in turn have duty-free access to imports of machines, equipment and intermediate inputs. This suggests that the structure of foreign investment in Malaysia strongly influences the country's trade structure.

E. Exchange rate policy

57. Since 1973, Malaysia has maintained a flexible exchange-rate regime for the Ringgit Malaysia (RM). The central bank, Bank Negara, has intervened, in principle, only to ensure orderly market conditions and avoid excessive fluctuations in the exchange rate vis-à-vis a basket of currencies weighted in terms of Malaysia's main trading partners and the currencies of settlement. These interventions translated into a *de facto* pegging to the US dollar and the Singapore dollar between 1975 and 1984 deemed desirable for the maintenance of public confidence in the ringgit. However, the appreciation of the ringgit relative to the other currencies which was a consequence of this strategy and the appreciation of the US dollar during the first half of the 1980s, coupled with the growing current-account and fiscal deficits caused bouts of speculation on the ringgit. As a result, the central bank decided in 1984 to let the ringgit depreciate and find its own level based on supply and demand.

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[22] Many observers believe that the main part of investment from Taiwan Province of China, is actually recycled Malaysian Chinese capital, sourced from abroad to take advantage of the tax breaks and other incentives associated with foreign investment but not with domestic investment, e.g., that equity restrictions under the NEP do not apply to FDI. The increase in investment from Hong Kong that occurred at the same time may be explained in similar fashion. It is, however, difficult to provide empirical evidence for this assertion.

[23] An important part of this foreign investment may actually come from transnational corporations operating in Singapore.

[24] Unfortunately, there is no data on FDI flows according to realization rather than approval.

Table 10a: Foreign investment in approved projects by country, 1985-1994, RM million and percentages

Country	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 1)
Australia	25.7	35.2	126.1	25.5	29.8	54.3	410.5	2125.6	52.1	164.7
	(2.7%)	(1.8%)	(6.1%)	(0.5%)	(0.3%)	(0.3%)	(2.4%)	(12.0%)	(0.8%)	(2.4%)
Hong Kong	28.2	65.9	88.9	298.4	352.1	375.0	600.6	78.6	93.8	779.3
	(2.9%)	(3.3%)	(4.3%)	(6.1%)	(4.1%)	(2.1%)	(3.5%)	(0.4%)	(1.5%)	(11.2%)
Indonesia	12.8	-	1.6	23.2	105.4	1083.3	1242.9	480.2	245.1	-
	(1.3%)	-	(0.1%)	(0.5%)	(1.2%)	(6.1%)	(7.3%)	(2.7%)	(3.9%)	-
Japan	264.4	110.3	715.1	1222.0	2690.4	4212.6	3705.9	2684.3	1661.2	1533.2
	(27.6%)	(5.5%)	(34.7%)	(25.1%)	(31.1%)	(23.9%)	(21.7%)	(15.1%)	(26.4%)	(22.0%)
Rep. of Korea	25.0	3.1	3.6	41.8	188.9	650.4	1818.7	99.4	111.1	26.2
	(2.6%)	(0.2%)	(0.2%)	(0.9%)	(2.2%)	(3.7%)	(10.7%)	(0.6%)	(1.8%)	(0.4%)
Philippines	0.6	0.7	0.2	-	0.3	40.6	2.2	18.3	1.8	1.1
	(0.1%)	(0.0%)	(0.0%)	-	(0.0%)	(0.2%)	(0.0%)	(0.1%)	(0.0%)	(0.0%)
Singapore	100.2	103.1	258.5	419.6	914.7	895.3	1114.3	442.4	521.9	529.8
	(10.4%)	(5.2%)	(12.5%)	(8.6%)	(10.6%)	(5.1%)	(6.5%)	(2.5%)	(8.3%)	(7.6%)
Taiwan Prov of China	31.9	10.8	243.0	829.6	2159.9	6339.1	3607.2	1500.0	894.2	1574.4
	(3.3%)	(0.5%)	(11.8%)	(17.0%)	(25.0%)	(36.0%)	(21.2%)	(8.4%)	(14.2%)	(22.6%)
United Kingdom	26.9	49.5	76.8	196.5	764.1	867.2	546.2	1304.0	44.1	69.1
	(2.8%)	(2.5%)	(3.7%)	(4.0%)	(8.8%)	(4.9%)	(3.2%)	(7.3%)	(0.7%)	(1.0%)
United States	111.9	53.0	162.7	535.2	320.8	567.3	1798.4	3298.7	1757.7	452.4
	(11.7%)	(2.7%)	(7.9%)	(11.0%)	(3.7%)	(3.2%)	(10.5%)	(18.6%)	(28.0%)	(6.5%)
Germany	8.0	2.1	28.5	116.8	309.6	126.9	193.3	72.8	64.9	38.1
	(0.8%)	(0.1%)	(1.4%)	(2.4%)	(3.6%)	(0.7%)	(1.1%)	(0.4%)	(1.0%)	(0.5%)
Others	323.4	1554.3	355.0	1169.4	817.0	2417.0	2014.8	5667.7	839.1	1803.7
	(33.7%)	(78.2%)	(17.2%)	(24.0%)	(9.4%)	(13.7%)	(11.8%)	(31.9%)	(13.3%)	(25.9%)
Total	**959**	**1988**	**2060**	**4878**	**8653**	**17629**	**17055**	**17772**	**6287**	**6972**
	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)

Source: Data for 1986-1988 from MITI (1994, p. 274); data for the other years from Ministry of Finance (1994, p. 8\xvi).
Note: 1) January - July.

Table 10b: Foreign investment in approved projects by industry, 1980-1994, RM million and percentages

Industry	1980	1985	1989	1990	1991	1992	1993	1994 [1]
Food manufacturing	50.0	58.6	290.7	325.7	232.9	215.1	185.1	17.2
	(20.2%)	(6.1%)	(3.4%)	(1.8%)	(1.4%)	(1.2%)	(2.9%)	(0.2%)
Textiles and textile products	8.0	31.3	511.2	874.2	401.9	1158.4	475.4	647.7
	(3.2%)	(3.3%)	(5.9%)	(5.0%)	(2.4%)	(6.5%)	(7.6%)	(9.3%)
Paper, printing and publishing	7.0	102.0	294.2	373.6	175.9	32.2	122.6	33.3
	(2.8%)	(10.6%)	(3.4%)	(2.1%)	(1.0%)	(0.2%)	(2.0%)	(0.5%)
Chemicals and chemical products	20.0	29.4	1016.4	1727.3	1973.7	1321.2	1762.5	735.3
	(8.1%)	(3.1%)	(11.7%)	(9.8%)	(11.6%)	(7.4%)	(28.0%)	(10.5%)
Petroleum and gas	1.0	0.8	223.8	2703.1	2564.7	11728.0	-	160.0
	(0.4%)	(0.1%)	(2.6%)	(15.3%)	(15.0%)	(66.0%)	-	(2.3%)
Rubber and rubber products	20.0	29.8	360.7	54.3	245.8	49.2	38.2	56.4
	(8.1%)	(3.1%)	(4.2%)	(0.3%)	(1.4%)	(0.3%)	(0.6%)	(0.8%)
Non-metallic mineral products	39.0	110.8	339.0	180.1	2032.1	334.3	114.9	499.8
	(15.7%)	(11.6%)	(3.9%)	(1.0%)	(11.9%)	(1.9%)	(1.8%)	(7.2%)
Basic-metal products	18.0	148.1	440.1	4538.7	3362.6	775.4	786.9	226.2
	(7.3%)	(15.4%)	(5.1%)	(25.7%)	(19.7%)	(4.4%)	(12.5%)	(3.2%)
Fabricated metal products	7.0	43.8	521.4	304.9	1673.8	101.7	95.9	77.1
	(2.8%)	(4.6%)	(6.0%)	(1.7%)	(9.8%)	(0.6%)	(1.5%)	(1.1%)
Electrical and electronic products	51.0	110.7	2720.8	3773.2	2716.1	957.5	1830.5	3123.6
	(20.6%)	(11.5%)	(31.4%)	(21.4%)	(15.9%)	(5.4%)	(29.1%)	(44.8%)
Transport equipment	2.0	186.4	136.8	279.5	215.9	78.2	317.5	158.0
	(0.8%)	(19.4%)	(1.6%)	(1.6%)	(1.3%)	(0.4%)	(5.1%)	(2.3%)
Miscellaneous	27.0	107.3	1797.9	2494.5	1459.6	1020.8	557.5	1237.4
	(10.9%)	(11.2%)	(20.8%)	(14.1%)	(8.6%)	(5.7%)	(8.9%)	(17.7%)
Total	**248**	**959**	**8653**	**17629**	**17055**	**17772**	**6287**	**6972**
	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)	(100%)

Source: Data for 1980 from World Bank (1992, p.25); data for 1986-1988 from MITI (1994, p. 274); data for the other years from Ministry of Finance (1994, p. 8\xvi)
Note: 1) January - July.

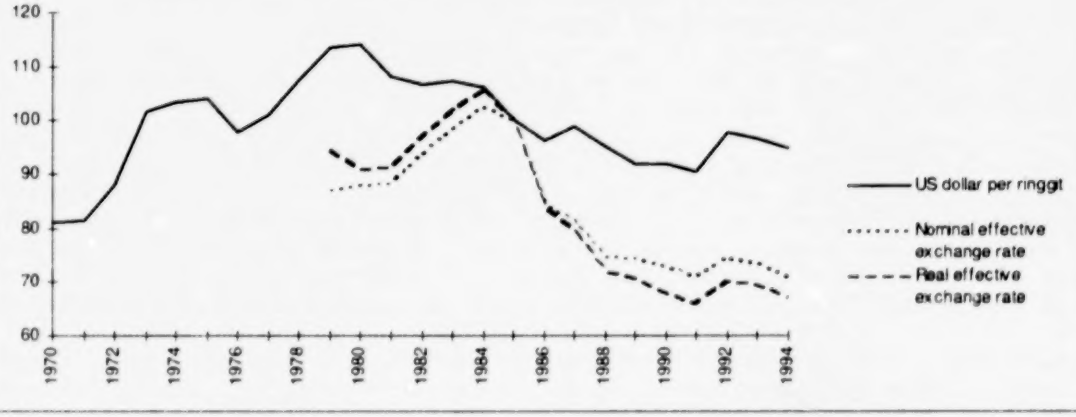
Table 11: Investment in approved projects by industry, 1993 and 1992

Industry	1993				1992			
	Number	Domestic Investment (RM mn)	Foreign Investment (RM mn)	Share of foreign in total investment	Number	Domestic Investment (RM mn)	Foreign Investment (RM mn)	Share of foreign in total investment
Chemical & chemical products	53	727.2	1,762.5	70.8	37	287.1	1,321.2	82.1
Electrical & electronic	200	474.4	1,830.5	79.4	211	622.1	957.5	60.6
Non-metallic mineral products	39	2,016.7	114.9	5.4	41	640.3	334.3	34.3
Basic metal products	22	1,001.3	787.0	44.0	45	1,861.3	775.4	29.4
Paper, printing and publishing	27	970.1	122.6	11.2	34	150.8	32.2	17.6
Transport equipment	37	754.8	317.5	29.6	31	306.2	78.2	20.4
Textiles & textiles products	47	419.3	475.4	53.1	114	177.1	1,158.4	86.7
Wood & wood products	42	374.1	269.6	41.9	47	367.6	276.6	42.9
Food manufacturing	49	238.5	185.1	43.7	52	137.2	215.1	61.1
Plastic products	50	136.4	88.9	39.4	68	443.9	216.4	32.8
Fabricated metal products	25	83.1	96.0	53.6	45	177.1	101.7	36.5
Furniture & fixtures	36	66.6	56.[illegible]	45.9	22	30.4	44.1	59.2
Machinery manufacturing	16	47.3	58.3	55.2	52	130.4	383.8	74.6
Rubber products	14	51.5	38.2	42.6	30	70.3	49.2	41.2
Beverages & tobacco	2	6.5	28.8	81.5	4	27.2	24.5	47.4
Leather & leather products	9	13.7	17.3	55.9	5	3.4	3.8	52.9
Scientific & measuring	3	9.2	17.4	65.5	3	4.9	2.0	28.5
Petroleum refineries/products	2	3.0	-	n.a	6	525.0	10,006.0	95.0
Natural gas	-	-	-	n.a	1	4,018.0	1,722.0	30.0
Miscellaneous	13	72.1	20.9	22.4	26	22.8	70.0	75.5
Total	686	7,465.5	6,287.2	45.7	874	10,003.0	17,772.1	64.0

Source: MITI (1994, p. 209)

58. Figure 5 shows that this exchange-rate policy led to a strong appreciation of the ringgit's real effective exchange rate in the early 1980s (peaking in 1984), followed by a drastic fall, except against the US dollar. The exchange rate has been relatively stable since 1989. The strong appreciation during the early 1980s had negative consequences on the country's external accounts, as it rendered exports uncompetitive, encouraged transfer of resources to the non-tradable sector of the domestic economy, and spurred expectations regarding an imminent depreciation giving incentive to capital flight. Conversely, the impressive performance of Malaysian manufactured exports in recent years may partly be attributed to the depreciation of the ringgit. Another exchange-rate related factor that has boosted manufactured exports may have been the appreciation of the currencies of Malaysia's main competitors in manufactured exports.[25]

Figure 5: Evolution of exchange rate indices, 1970-1994, period averages, 1985=100



Source: International Financial Statistics, Yearbook 1995
Note: Data on the nominal and real effective exchange rates are not available prior to 1979

F. Fiscal policy

59. During the 1970s, the main adverse implications of commodity price cycles for the domestic economy could be cushioned by counter-cyclical, mainly fiscal, policy measures. The Government's expectation that the decline in world commodity prices in the early 1980s would be temporary led to the adoption of countercyclical fiscal policies, with a view to maintaining domestic income levels. Apart from tax cuts, the main elements of this spending programme included accelerated public investment and expenditure programmes with emphasis on key industries as well as the provision of economic services in agriculture

[25] In 1991, the real exchange rate index (1985=100) reached 124.6 for Thailand, 123.1 for Hong Kong, 119.1 for the Republic of Korea, and 101.1 for Singapore, while it was 66.1 for Malaysia [UNCTAD (forthcoming)].

and rural development, commerce and general administration. However, with the decline in commodity prices proving to be secular rather than temporary, the combination of falling commodity prices and expansionary fiscal policy led to serious fiscal and current account deficits. These deficits were financed by heavy borrowing, both domestically and, increasingly, abroad, with a resulting sharp rise in external debt.[26] As these deficits were perceived to be unsustainable, the Government resorted to a sharp cut in development expenditure, bringing down the overall public sector deficit from 19 per cent of GNP in 1982 to 8 per cent in 1985, largely as a result of halving federal development expenditure (see table 4). This, together with the collapse of commodity prices and the Government's incapacity to adopt counter-cyclical policies due to already high deficits, led to a negative GNP growth rate in 1985 for the first time in the country's economic history. In the light of the large budget deficit, the Government faced a dilemma: budgetary restraint was needed and investment in infrastructure was desirable.

60. Economic fortune turned in 1987 in response to several factors: first, the recovery of world-market prices for primary commodities, albeit short-lived; secondly, the fact that a depreciation of the ringgit against the currencies of major trading partners and low domestic inflation contributed to a depreciation of the ringgit's real effective exchange rate by 16 per cent in 1986, which, together with an appreciation of the currencies of major competitors (the Republic of Korea and Taiwan Province of China), helped fuel higher demand for manufactured exports; and thirdly, attempts by the Government to foster growth by (i) deregulating and liberalizing the economy through a relaxation of controls; (ii) raising the exemption threshold for industrial licenses; and (iii) easing the regulations governing equity and employment in foreign-owned companies as well as land acquisition. Continuing strong export growth and a rise in FDI as well as strong domestic demand contributed to a quick recovery from the 1985-1986 recession, as well as to high GDP growth rates and prepayment of external debt thereafter. Since the mid-1980s, the main objectives of the Government's fiscal policy have been to strengthen the national budgetary position and to reduce the size of the public sector while sustaining economic recovery through a redeployment of development funds to construction and labour-intensive projects. The consolidated public sector deficit was in fact reduced from 19 per cent of GNP in 1982 to 5 per cent in 1988. This improvement resulted from both higher revenues and expenditure restraint at the federal level.

G. Monetary policy

61. Monetary policy in Malaysia has, in general, been aimed at (a) ensuring that the liquidity generated in the banking system by expansionary fiscal policy would not evolve into a source of monetary instability, and (b) promoting economic development.[27] The main instruments used for this purpose were interest rate policy and lending guidelines to commercial banks. In addition, export-related financial facilities have been used to promote export growth and a broadening of the country's export structure.

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[26] 'Captive' savings in the Employees' Provident Fund were the primary financial source of the Government's direct development efforts until the early 1980s. By contrast, Malaysia's external debt rose from RM 10 billion in 1980 to RM 42.5 billion in 1985 [Bank Negara (1994, p. 21)].

[27] For a detailed account of events and an assessment of monetary policy since Independence, see Bank Negara (1994, pp. 433-478).

62. Bank Negara has modified the way interest rates are determined several times over the past 20 years. Prior to 1978, Bank Negara determined, in consultation with the commercial banks, the minimum lending rate and the ceiling on deposit rates. The central bank had adopted this administered interest rate regime mainly in order "to promote the growth of indigenous banks by limiting rate competition" between domestic and foreign banks [Bank Negara (1994, p. 131)]. Between 1978 and the end of 1983, commercial banks could determine their own interest rates on deposits and prime lending rates. However, commercial banks tended to delay downward adjustments of the lending rates. Bank Negara thus introduced a base lending rate and required commercial banks to peg their lending rates to this rate. Bank Negara also temporarily suspended the free determination of deposit interest rates between 1985 and 1987 to restrain the rise in deposit interest rates which reflected the banks' attempt to attract savings in light of their tight liquidity position following the collapse of many companies during the economic crisis of the mid-1980s. As a consequence of the way the base lending rate was operated, the period between 1987 and 1990 was characterized by 'mild' financial repression [World Bank (1993, p. 240)] intended to help stop the series of company bankruptcies and allow for the recapitalization of banks in the aftermath of the 1985-1986 recession. Thus financial repression was an instrument mainly for ensuring a viable financial system rather than for promoting development or diversification. Given that the ringgit had full current-account convertibility, an only limited level of financial repression was operational, that is, it did not exceed the spread in intermediation costs between holding deposits in Malaysia or abroad. In February 1991, the base lending rate was abolished with the result that interest rates in Malaysia have since been determined by market forces, except for interest rates on priority sector lending - that is, for the purchase of houses with a value of not more than RM 100,000 - which are still subject to guidelines set by the central bank.[28]

63. The Malaysian authorities have operated several forms of subsidized and directed credit. During the 1970s and the early 1980s, specific economic sectors were favoured such as the export-oriented, resource-based rubber and palm-oil sectors as well as, and particularly during the early 1980s, the automotive, cement and steel sectors. In order to ensure that new fixed investment required for economic recovery from the 1985-1986 recession was not delayed for a lack of available finance, the Government created the New Investment Fund (NIF) in 1985 "to promote investments in new productive capacity in manufacturing, agriculture, tourism and mining. These sectors were seen as offering potential to generate or save foreign exchange in the short and medium term" [Bank Negara (1994, p. 177)]. Funding under the NIF was terminated at the end of 1987. In order to ensure that domestic savings are channelled into Government-funded projects, the Employees' Provident Fund - established in 1951 - to which both employers and employees have to make statutory payments, was legally obliged to invest 70 per cent of its annual investible funds in Malaysian government securities.

64. With the general liberalization and deregulation policy pursued since the mid-1980s, the Government has abandoned large-scale industry-related directed credit in favour of more functionally directed credit, in particular to small

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[28] Until March 1989, interest rate caps also applied to loans extended to the Bumiputra community and to small-scale companies.

and medium-sized enterprises.[29] For example, the Principal Guarantee Scheme - managed by the Credit Guarantee Corporation Malaysia Berhad with capital subscribed by Bank Negara and commercial banks - provides a credit cover of up to a maximum of 70 per cent of the unsecured portion of the credit facilities granted [ibid. (p. 169)]. An example of diversification-oriented, functionally-directed bank lending regarding commodities is the soft loan scheme for furniture and food-based products for Bumiputera small and medium-sized enterprises. In 1993, the first year of operation, a sum of RM 10 million was allocated under this scheme [MITI (1994, pp. 267-268)].

65. The third form of directed credit has been based on social objectives, namely the development of a Bumiputera commercial and industrial community. Bank Negara establishes lending guidelines to this end which stipulate minimum requirements for lending to the Bumiputera. Through the lending guidelines issued in 1992, for example, commercial banks were required to extend at least 20 per cent of their total loans to the Bumiputera community [Bank Negara (1994, p. 165)].

66. Regarding export-related financial facilities, Bank Negara has established bilateral payment arrangements with central banks of several other countries, as a means to diversify Malaysia's export structure. Such arrangements convert commercial risk related to trade into sovereign risk as the central banks pay each other - thereby facilitating settlement of monetary obligations among commercial banks in both countries - or guarantee payments for imports undertaken by companies or individual residents in the respective countries. It appears that these arrangements have been a powerful tool to strengthen Malaysia's trade with other developing countries.[30] Bank Negara is operating several types of this arrangement. The 'Iranian model' provides guarantees for payment default by importers, that is, the central bank pays the exporter if the importer fails to pay for goods received; this system is usually applied with countries that do not face constraints in their use of external reserves but do not have a modern banking system. In the 'ALADI' model, exporters receive payments in domestic currency from the respective central bank, while central banks periodically settle among themselves the net amount due to each other in US dollars; this means that the exchange rate risk is carried by the central banks. Operating this system requires the country of the partner central bank to have both sufficient external reserves and a modern banking system. The Revolving Credit model is based on the ALADI model with the difference that Bank Negara grants a credit limit in US dollars to the other central bank, while the debtor central bank issues a list of goods and persons entitled to trade under this arrangement. Finally, the Palm Oil Credit and Payments model is equivalent to the Revolving Credit model but palm oil exports from Malaysia are the only eligible product while the period of deferred payment is set at a maximum of two years [for details see MITI (1994, p. 143-147)].

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[29] As a corollary, the new EPF Act, 1991, has given the Fund greater flexibility to manage its resources relaxing the statutory requirement to invest in government securities from 70 per cent to 50 per cent of its annual investible funds provided that its cumulative holdings of such securities does not fall below 70 per cent of its total investment. This move has enabled the Fund both to diversify its investment portfolio and to obtain better yields [Bank Negara (1994, p. 253)]. The actual share of EPF funds invested in government securities decreased from more than 90 per cent in the 1960s through the early 1980s to about 55 per cent in 1993 [Ministry of Finance (1994, p. 177)].

[30] In 1994, Malaysia had 578 bilateral payment arrangements with 19 countries [MITI (1994, p. 147)].

67. In addition, the Malaysia Export Credit Insurance Berhad (MECIB) extends insurance coverage of up to 85 per cent of the gross value of a transaction to Malaysian exporters against the risk of non-payment by their foreign buyers, as well as guarantees to commercial banks and other financial institutions against non-payment of export-related working capital loans granted to direct and indirect exporters. MECIB also offers a guarantee to overseas investment which is either new or an injection of new capital into an existing project for expansion or modernization purposes, and which either utilizes raw materials from Malaysia, supplies inputs to industry in Malaysia or contributes to South-South cooperation. In such cases, MECIB covers up to 90 per cent of any losses as a result of transfer restrictions, expropriation, war, civil disturbances or breach of contract [Ministry of Finance (1994, p. 231)].

68. In 1977, Bank Negara introduced an Export Credit Refinancing (ECR) Scheme with a view to rediscounting export bills for eligible products for post-shipment finance at interest rates below market levels, so as to raise the competitiveness of exporters. Post-shipment loans have been extended by commercial banks to exporters, thereby allowing them to obtain funds to meet cash flow requirements immediately upon shipment of goods. Originally, loans were given at a rate of 5 per cent for three months and the Bank Negara rediscounted them at 3.5 per cent. Given the prevailing interest-rate margin of 3 to 6 per cent, the before-tax export subsidy effect of this scheme was relatively low. At the same time, a list of eligible goods was published, emphasizing textile and edible oil industries.

69. The ECR-scheme has been upgraded and modified several times in order to match changing export conditions. In 1979, a pre-shipment window was added to the facility to provide working capital to exporters and their domestic suppliers to finance overhead expenses and domestic input purchases. In a comprehensive review of the Scheme in 1985-1986[31], the positive list of eligible goods was replaced with a negative list with the result that since then almost all manufactured goods have been eligible as well as processed food products such as cocoa butter, canned pineapples and pineapple juice, rubber and wood products, and some primary commodities such as natural rubber and crude vegetable oils. In addition, to be eligible, goods have to meet a minimum local content requirement of 30 per cent of the raw material used and have a minimum value-added of 20 per cent. Bank Negara can on request waive these requirements on a case-by-case basis.

H. Policy regarding cooperation between the Government and the private sector

70. The Government has collaborated closely with the private sector, in particular since 1986, in order to ensure the complementarity of Government and private-sector activities through participation of the private sector in shaping and implementing government policies. Relations between the Government and the private sector tended to be somewhat tense between 1970 and the mid-1980s, partly as a result of the NEP-requirement that all companies must have a minimum Bumiputera participation of 30 per cent. Collaboration during this period was largely confined to a number of consultative panels within ministries whose main purpose was to cut red tape. In 1983, formal public-private cooperation was

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[31] In a second phase of this review in 1989, several new systems were introduced including the Domestic Letters of Credit System, the Certificate of Performance Method, the Cash Reimbursement System and the Domestic Purchase Order System [see GATT (1994a, p. 105)].

introduced in the quest for economic growth with equity and embodied in the slogan "Malaysia Incorporated". Annual dialogue sessions have been organized at the Ministry of International Trade and Industry, the Ministry of Finance, the Ministry of Human Resources and the Ministry of Primary Industries to foster the exchange of ideas and provide for a feed-back mechanism. Participants of these sessions can raise issues verbally but also beforehand prepare written memoranda to be discussed at a session. Dialogue meetings have generally been judged useful. They have benefitted from the fact that the private-sector participants represent mature and professionally staffed trade and industry associations and can efficiently voice their associations' concerns and transmit information pertaining to government policies affecting their interests.

71. The gradual improvement in public-private cooperation has so far culminated in 1991 with the establishment of the Malaysian Business Council as part of the strategy to make the private sector the main dynamic factor of economic development. The Council consists of ten ministers, eight senior public servants and 44 leading businessmen and is chaired by the Prime Minister. It meets two to three times a year in order to (a) facilitate a free flow of information and ideas between the public and the private sectors; (b) address problems pertaining to industrial and commercial development and remove impediments to economic growth; (c) create a better understanding and relationship between the public and the private sectors; and (d) identify and promote areas of cooperation and collaboration between the public and the private sectors.

72. Formal commodity-specific consultative procedures have also taken place given that the board - of institutions such as the Rubber Research Institute, the Rubber Development Corporation or the Palm Oil Research Institute - includes members coming from both the public and the private sectors whereby the meetings are chaired alternately by a representative of the Ministry of Primary Industries and one of the private sector. Such meetings have helped balance interests of subsectors and identify diversification potentials as well as research and development and market penetration activities required to this effect.

73. The Government has also closely collaborated with the private sector regarding export promotion and marketing assistance, including through the organization of trade fairs, exhibitions, etc. Until 1993, export promotion and marketing assistance was coordinated by the Malaysian Export Promotion Centre (MEXPO) which was part of MITI. In order to concentrate under one roof the provision of services such as market research, market information, product design, commercial intelligence, training and product development, the Government created the Malaysia External Trade Development Corporation (MATRADE) in June 1993. Even though MATRADE is formally still part of MITI, it obtained some autonomy regarding the choice of personnel and the administration of financial resources in order to allow for a more aggressive export-marketing strategy. For example, MATRADE receives a lump sum for a budget year which it can use at its discretion without having to account to MITI for each ringgit spent; however, MATRADE is accountable to Parliament for its expenditure. MATRADE also can employ consultants from the private sector with hands-on experience for specific purposes, such as training courses to Malaysian exporters on market access barriers or the business climate on specific targeted export markets. Participants of such training courses are charged a fee to cover for the cost involved in holding the course.

Chapter III

Commodity-specific issues related to Malaysia's diversification experience

A. Rubber products

74. Malaysia has been a major - and sometimes the leading - supplier on the world market for natural rubber since the early 1900s. The duration of this position shows that Malaysian rubber producers have been able to adjust quickly to economic and technical changes in the rubber sector; for example, the quality of rubber trees was upgraded and production technology improved to stem the inroads made in world rubber consumption by synthetic rubber in the 1950s and 1960s; technological adjustments in rubber treatment were made to meet the increasing demand of consumers for technologically specific rubber. The development of downstream processing activities could thus build on both the country's large production of natural rubber and its - relative to other rubber-producing countries - high level of managerial and technical skills in the natural-rubber sector.

75. Processing activities in the Malaysian rubber sector started in the 1930s. However, their scope was limited to the needs of domestic consumers until the beginning of the 1980s. The pace of rubber-based processing activities increased in the early 1980s, in response to measures taken by the Rubber Task Force Committee created in 1972. These measures included the undertaking of studies to assess the growth potential of rubber-based processing activities and to identify market potentials and marketing channels for such products. One of the recommendations of these studies was to develop processing activities for the manufacturing of latex products; Malaysia was considered to have a comparative advantage in this area, as the country was then supplying about 85 per cent of the world's demand for latex concentrate then and latex-based processing is less technology-intensive than other processing activities in the rubber sector. Further, a technology centre was established at the Rubber Research Institute of Malaysia (RRIM) with a view to providing training and facilitating the transfer of technology [Farouk (1992, p. 7)]. Combined with these measures, the investment incentives provided in FTZs helped to attract foreign investors to latex processing and allowed Malaysia to gain access to the needed technology. A company from Australia was the first foreign investor in this sector to take advantage of investment incentives in FTZs when it set up production facilities for latex household gloves in 1976. Soon other foreign investors from the United States and Italy started to produce other latex products, with the result that Malaysia became a significant exporter of latex products by the early 1980s.

76. Rubber-processing activities gained further impetus with the inclusion of rubber products into the IMP (1986-1995). One of the main objectives of the IMP was to set rubber-processing activities among the leading resource-based manufacturing sectors, to encourage greater domestic utilization of natural rubber so as to raise domestic value-added and foreign-exchange earnings, and to make the country a major tyre and tube exporter on the world market. The incentives connected with the priority attention accorded by the Government under the IMP were reinforced by external developments related to the fear of AIDS transmission. Production activities in rubber processing strongly increased by both domestic and foreign investors during the second half of the 1980s; Malaysia now produces a variety of intermediate and finished rubber goods, including tyres, inner tubes, footwear, latex goods, industrial rubber goods (such as belts, tubes and hoses) and a wide range of general rubber

products. Wholly-owned domestic companies have accounted for about 80 per cent of investors, producing about 20 per cent of output; foreign investors engaged in joint ventures have come from Taiwan Province of China, France, the United States of America and Japan. Numerous small and medium-sized domestic companies have been producing mainly for the domestic market but they "are generally weak in export trade and are unable to compete in terms of price, quality, specifications and services with the few large companies established wholly or jointly by foreign transnationals" [UNIDO (1991, p. 75)].

77. In order to encourage rubber-based processing activities as well as a greater utilization of indigenous raw materials,[32] the Government has accorded a discount of MR 0.20 per kg of rubber to those manufacturers producing rubber products for export and purchasing their inputs of natural rubber from any of the three government agencies handling smallholder rubber, i.e., the Federal Land Development Agency (FELDA), the Malaysia Rubber Development Corporation (MARDEC) and the Rubber Industry Smallholders Development Authority (RISDA). In addition, manufacturers of rubber-based products were allowed a discount on their electricity bill, depending on the share of exports in their company's production. A company which exported its entire production enjoyed an allowance of 20 per cent [UNIDO (1991, p. 148)]. Both these schemes were effective between 1985 and 1990 until the Government abolished them, considering that Malaysian exporters could compete successfully in the world market without specific support. This is an example of the Government's approach: to give specific support for a limited period of time in order to encourage companies to adjust to new conditions; eventually, however, companies are expected to be to withstand competition.

78. Table 12 shows that latex products account for the bulk of Malaysia's successful diversification in rubber-good exports; in the early 1990s, the country had evolved as the world's biggest exporter of household gloves, examination gloves, surgical gloves, catheters and latex thread [Farouk (1992, p. 8)]. Exporters of latex products are mainly foreign manufacturers who already possessed competitive technology and marketing expertise, and who have shifted their production sites to Malaysia because of easy access to the natural-resource input needed and the investment incentives granted [ibid.]. The table also shows that exports of footwear and tyres have grown considerably less rapidly than exports of latex products. The fact that both footwear and tyres generally have a much lower content of natural rubber than latex products, and that their production therefore relies to a much larger extent on imported materials may explain this difference in performance.[33] Domestic tyre producers have engaged in a joint venture with one of the big international tyre producers in order to get access to the technology and capital required for a competitive production of car tyres. The output of this joint venture has been sold mainly

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[32] In 1990, local use of domestic rubber production amounted to 14 per cent [Government of Malaysia (1991, p. 35)].

[33] The production of car tyres, for example, requires a substantial amount of synthetic rubber. An import duty on synthetic rubber was introduced in the mid-1980s. However, the fact that the competitive edge of Malaysia's rubber sector is knowing how to use natural rubber and that the total amount of synthetic rubber utilized in domestic tyre production has been relatively small has restrained incentives for setting-up a company producing synthetic rubber in Malaysia. Moreover, the fact that processing national rubber into tyres is accompanied by a very substantial increase in bulk and that the world market of car tyres is controlled by a small number of companies with well-established brand names has constrained vertical diversification in this sector in all rubber-producing developing countries.

on the domestic market, for example, tyres for the domestic passenger car ('Proton'), while part of the production has been exported to developed countries as a complementary supply to that of the main international tyre producers, as well as to less developed markets in Africa and Asia. Domestic tyre producers have also successfully built on their knowledge of how to use and work with natural rubber and are starting to export tyres that require a very substantial input of natural rubber, that is, for aircraft and big earthmovers, which must partly be tailor-made.

Table 12: Export of rubber products by product group, 1980-1993 (thousands RM)

Year	Tyres	Inner tubes	Foot-wear	Latex products	Industrial rubber goods	General rubber goods	Total
1980	12,776	1,892	72,926	80,780	1,192	45,709	215,275
1989	39,225	7,214	87,655	1091,785	12,700	124,951	1363,530
1990	47,749	9,855	105,940	1338,522	16,073	151,131	1669,270
1991	78,430	14,488	115,394	1718,894	31,676	175,741	2134,623
1992	126,583	17,958	118,124	2000,293	33,613	188,617	2485,188
1993	149,592	15,644	205,190	2330,200	33,125	255,750	1989,501

Source: Ministry of Primary Industries (1994b, p. 69)

79. A major constraint to the export of processed rubber goods, in particular of tyres and tubes, has been the lack of technological know-how. The major international tyre producers have, in general, been reluctant to transfer technology to developing countries attempting to develop their own tyre exports. Indigenous research and development activities in the rubber sector have mostly been concentrated in the primary sector; producers of rubber products have often had to rely on technical cooperation with their foreign partners in order to take advantage of the latest technology. In order to ensure that Malaysia is in the forefront of research and development in the rubber-goods sectors, the Government has started to give companies and research institutions more incentives to undertake indigenous research, with a view to advancing production technology, improving tyre retreading and deprotenization of rubber, and developing new products for engineering activities. Between 1988 and 1994, the Ministry of Science, Technology and Environment allocated a total of RM 10.6 million to RRIM under its programme on intensified research in priority areas. However, this investment has apparently not yet led to commercially applicable results.

80. Marketing limitations such as competition from well-established brands and the existence of segmented markets have also constrained the development of sustainable exports of rubber-based products from Malaysia. Regarding latex-based products, about one-fourth of the glove-making companies were established as part of large international companies able to provide good market-access conditions, along with the manufacturing and marketing expertise required to produce high-quality, easily marketable products. The smaller domestic companies producing latex-based goods, by contrast, have been faced with market access problems owing to their lack of experience in production technology, export marketing and, in particular, quality control.

81. To summarize, the significant expansion of rubber-exports from Malaysia since the beginning of the 1980s can be attributed to (a) the fact that the country has been one of the world's leading producers of natural rubber; (b) the country's relatively high level of technological knowledge on how to use natural rubber; (c) the Government's firm commitment to develop the rubber-goods sector, as expressed by the conscious policy of granting favourable investment conditions to foreign companies active on the world market for rubber goods and able to provide the technology and capital as well as marketing expertise for the successful export of these products; and (d) the steep increase in world demand for latex products, in particular examination gloves, in recent years. The strong demand for latex products has, however, also led to a relatively narrow export concentration on latex products. Although success in exporting tyres has alleviated this concentration, for further growth and a balanced development of Malaysia's rubber-goods exports, it may prove necessary to provide incentives to investors to set up ancillary structures such as the domestic production of synthetic rubber and obtaining commercially applicable results from indigenous research and development activities in the rubber-goods sector.

B. Palm oil

1. General developments

82. Since the mid-1970s, Malaysia has been the world's largest producer and exporter of palm oil, with a share of about 60 per cent of total world production and 65 to 70 per cent of total world exports. At the end of the 1980s, about one-third of the country's cultivated land was planted with oil palms. Oil palms were first commercially planted in Malaya in 1917 but yielded a relatively minor crop until the late 1950s when the country started an economic diversification strategy away from rubber. This strategy emphasized palm-oil production because of (a) the favourable climatic conditions for oil palm plantations; (b) the existing infrastructure in rubber estates could be used for large-scale palm-oil production; and (c) profits drawn from palm-oil production compared favourably with those from rubber production so that oil palms were often substituted for rubber trees on estates of limited size. In addition, the Malaysian Government strongly supported the expansion of oil palm plantations after 1960, particularly through the large resettlement efforts of the Federal Land Development Authority (FELDA).

83. The evolution of palm oil production is illustrated in table 13. The table shows the steep increase in both local palm oil production - production rose at an annual rate of about 14 per cent during 1960-1993 - and local palm oil refining. The rate of growth of the latter was particularly steep during 1974-1976 when it reached 155 per cent per annum. The result was that during the 1970s Malaysia developed from being an exporter of crude palm oil to an exporter of refined palm oil and palm oil products. More recently, domestic consumption of palm oil has increased, owing to the development of Malaysia's oleochemical industry. Oleochemicals are used as inputs for the production of detergents, toiletries and cosmetics.

Table 13: Production, export and local refining of palm oil in Malaysia, 1965-1993 (in tons)

Year	Production of crude palm oil	Exports of crude palm oil	Local refining [1]
1965	150,400	141,477[2]	n.a.
1970	431,100	373,280[2]	11,652[2]
1975	1,258,000	829,192[2]	291,063[2]
1980	2,573,137	197,700	2,375,437
1985	4,133,392	13,100	4,120,292
1987	4,533,021	170,700	4,362,321
1990	6,094,622	102,100	5,992,522
1991	6,141,353	89,900	6,051,453
1992	6,373,457	69,900	6,303,557
1993	7,402,931	59,300	7,342,631

Sources: Pletcher (1991, p. 626) Ministry of Primary Industries (1988b, pp. 48 and 54; 1994b, pp. 35 and 40), and UNCTAD database.

Notes [1] Although Malaysia's statistical sources cite these figures as "local consumption", virtually all of the crude palm oil locally consumed is refined. The figures do not include imported crude palm oil refined in Malaysia; however, it appears that the quantity imported has been small compared to local production.

[2] Peninsular Malaysia only.

84. Research efforts by both the Government and the private sector have been a crucial factor in developing palm oil exports. While large estates usually had their own research units, in 1979 the Government established the Palm Oil Research Institute of Malaysia (PORIM), which was to conduct research on its own and coordinate oil-palm research throughout the country. PORIM's main objective has been "to increase the production of palm oil at the lowest cost and with the highest quality" [Parameswaran (1987, p. 287)]. It has been funded mainly by the industry itself through a levy on production of RM 5 per ton. This levy has provided over RM 12 million a year for palm-oil related research. A joint committee of industry and government representatives has been in charge of deciding PORIM's research programme which covers all aspects of production and marketing.

85. One of the first results of these research efforts was the technique of replacing manually assisted pollination by weevil pollination in 1982. The introduction of weevil pollination resulted in a steep increase in productivity - it demanded less labour input and led to a larger quantity of fruit on each bunch. Specifically designed tools for the mechanization of harvests also increased productivity. Mini-tractors and trailers were also introduced along with mechanized loading for in-field work and transportation. Research achievements in milling and refining have led to the adoption of a high level of automation, thus improving processing efficiency. Demand for palm oil could

be fostered by research results showing that palm oil is superior to other oils in terms of oxidation stability and its performance during frying applications. Moreover, new end-uses have been created, for example, by developing processing technologies that have allowed "golden palm oil" to be produced which is apparently the only known inexpensively produced, refined vegetable oil that is rich in carotenoid. New technologies have also allowed Vitamin E to be extracted from palm oil - which is said to perform well in breast-cancer therapy - as well as carotene - a precursor of Vitamin A. Both these products have been commercialized in Japan. Regarding non-food applications, the use of palm methyl esters (palm diesel) as a substitute for diesel fuel has been tested and found to be technically feasible.[34]

86. Research results have also been at the centre of activities concerning the controversy with the American Soybean Association in the mid-1980s. Palm oil was alleged to have a higher percentage of saturated fats than soya-bean oil, and hence to be partly responsible for the high incidence of coronary heart diseases in the United States. This allegation was made despite the fact that palm oil accounted for less than 2% of the total fat intake of the United States population. Nutrition studies which were partly sponsored by the Malaysian Government and carried out by reputable scientists all over the world in response to this allegation provided a better understanding of the nutritional and health attributes of palm oil consumption and were all in favour of palm oil.

87. Such examples illustrate how research has been market-driven, providing outcomes with immediate commercial relevance. They also show that Malaysia is going beyond the refined palm-oil stage and is building up a resource-based oleochemical industry. Although it is difficult to assess precisely the impact of financial incentives on specific research activities, it would appear that the substantial level of research and development activities in the palm oil area has at least partly been due to the fact that research and development in agriculture have enjoyed preferential treatment since the inception of the Promotion of Investments Act in 1976 (see chapter II, section D.3).

2. Horizontal diversification

88. Apart from successful research and development activities, main factors underlying Malaysia's horizontal diversification into palm oil include the growing international demand for palm oil,[35] which provided for market opportunities and profitability, and the country's favourable factor endowment regarding both physical (climate, topography, plantation infrastructure) and human resources (plantation management and agronomic expertise). The shift to the oil palm was also boosted by the fact that oil palms take only four years to mature after field planting (while rubber trees take six to seven years), and that they are quite resistant to indigenous pests and diseases. This impetus was further supported by the fact that palm oil production is much less labour-intensive than rubber production. This aspect gained importance with the increasing shortage of labour on estate plantations. According to estimates of

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[34] For further details, see Basiron and Kifli (1994).

[35] Both world demand for vegetable oilseeds, oleaginous fruits and oils, and the share of palm oil in total world exports of vegetable oilseeds, oleaginous fruits and oils increased substantially during the 1960s and 1970s. See UNCTAD *Commodity Yearbook* for statistical evidence.

the World Bank[36] for 1985, the return per work day for rubber production was RM 9, compared to RM 92 for palm oil, RM 53 for cocoa and RM 12 for coconuts, respectively.

89. As has been noted, " ... much of the credit for this success lies with the government of Malaysia for its active investment in palm oil production (primarily through FELDA settlement schemes) and its exercise of regulatory powers and marketing policies with respect to the industry" [Pletcher (1991, pp. 626-627)]. The terrain used for oil palm plantations was substantially increased after 1962 both through the Government's adoption of a policy allowing rubber replanting grants to be used for planting oil palms and its tax policy regarding rubber and palm oil. Replanting grants were funded by duties levied on the palm-oil industry's exports; they allowed both small-holder producers and estates to bridge financial losses during the switch from rubber to palm oil production. Regarding the tax policy, the Government had introduced a tax on rubber exports in 1951 to build up funds for replanting; later it supported substitution of palm-oil for rubber cultivation by limiting the tax levied on oil palm to a range between 4 and 8 per cent, compared to 17 to 24 per cent for rubber, of gross revenues per hectare [Jenkins and Lai (1991, p. 78)]. With the continuing good prospects for palm-oil exports, the Government converted the tax into a graduated tax, designed to stabilize farmgate producer prices and at the same time ensure funds for public investment.

90. Publicly managed resettlement schemes have been one of the most salient features of government policies in the palm oil sector. FELDA was established in 1962 to offer previously landless peasants the opportunity to become smallholder farmers. Since then it has been a main pillar of the Government's efforts to alleviate rural poverty. FELDA's responsibilities include opening up virgin land, establishing a plantation and its young oil palms, and constructing the scheme buildings including houses for settlers. The settlers receive a FELDA loan for income support during the three years they work before the first harvest. FELDA deducts a certain amount from the sales of the settlers' crop to the FELDA oil mill over a period of 15 years in order to recuperate about 70 per cent of the costs of setting up a resettlement scheme. During this period, FELDA also exerts firm managerial control over the scheme in order to insure the scheme's coherence as a single unit of production and to exploit the scheme's economies of scale. While this firm control may have helped maintain efficiency, productivity and high quality of palm oil production within the scheme, settlers have felt that FELDA has occasionally been too rigid. Settlers have also expressed concern about their property rights upon completion of the loan repayments. Various approaches were adopted to deal with this issue before it was announced, in October 1988, that settlers on all FELDA schemes would be granted individual land titles once their debts had been repaid.

91. Adoption of the NEP with the commitment to eradicate poverty and to restructure industry ownership also had profound implications for the ownership of palm oil estates which used to be predominantly foreign owned. The Government established the Permodalan Nasional Berhad (PNB - National Equity Corporation) in 1978 and entitled it to use public funds to purchase shares of foreign companies. These shares were combined in a portfolio, parts of which were sold to Bumiputras. This take-over process has usually taken the form of the foreign-owned parent company creating a subsidiary company domiciled in Malaysia, with PNB's acquiring a majority of the company through the stock

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[36] World Bank (1986, p.128).

market. As a result, by the mid-1980s, PNB had acquired control over all the major plantation companies in Malaysia including the two largest rubber and palm oil plantation companies in the world [Pletcher (1991, p. 630)]. The Government has, however, not interfered in the management of the companies' financial resources.

3. Vertical diversification

92. As part of the NEP, the Government has actively encouraged downstream processing and refining of palm oil, with a view to building a resource-based industrial sector. Malaysian firms started this venture by producing semi-refined products, such as neutralized palm oil, crude olein and crude stearin; however, by the end of the 1970s, emphasis had shifted to the production of fully processed products, including refined-bleached-deodorized palm oil and olein. Crucial in this successful vertical diversification effort was the export duty structure that the government introduced, which exempted processed palm oil products from some or all duties depending on the degree of processing; duty exemptions of 100 per cent were granted for fully processed products.[37] The structure of the sliding export tax for palm oil (shown in table 14), is such that the duty on crude oil exports is so high that practically none has been exported in recent years. Moreover, the higher the price for palm oil, the greater the advantages of exporting processed rather than unprocessed products. The impact of the sliding export tax on downstream processing activities has been supported by the fact that, since 1986, investors in this area have been eligible for Pioneer Status and Investment Tax Allowance for their capital outlays.

93. Evidence shown in tables 3 and 15 on the destination of Malaysia's exports of refined palm oil and all palm oil exports suggests that developed countries have mainly imported crude palm oil, while developing countries have accounted for the bulk of the country's exports of refined palm oil and palm oil products: in 1993, the European Union, Japan and the United States together accounted for only 14.1 per cent (22.9 per cent in 1980) of refined palm oil exports from Malaysia. By contrast, China, Egypt and in particular Pakistan have gained in importance as importers of Malaysia's exports of refined palm oil. Table 16 shows the extent of tariff escalation employed by the developed countries mentkioned, with respect to palm oil. The tariff structure for the European Union as shown in table 16 led to a weighted average of tariffs of 4 per cent on crude palm oil and 14 per cent on refined palm oil before the conclusion of the Uruguay Round on multilateral trade negotiations - the post-Uruguay Round figures are 0 per cent for crude and 9 per cent for refined palm oil [Othman (1994, p.16)]. Countries where palm oil processing capacities are high and always in excess of locally available crude oil also tend to import crude rather than refined palm oil. In response to this, Malaysia has been involved in joint venture projects regarding palm oil refineries - which process crude oil coming from both Malaysia and the host country - in China, Egypt and India, in an attempt to enjoy part of the value-added through refining and to gain a foothold in these countries for downstream palm oil products.

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[37] Duties on commodity exports were initially introduced for revenue purposes. The objective of using the export duty on palm oil to encourage the development of downstream processing activities has been followed since the 1970s.

Table 14: Export duty and duty exemption formula for palm oil

Export duty on palm oil		
Gazetted FOB price		Tax rate
On the first RM 650		Nil
Plus on the next RM 50	Per ton *ad valorem*	10 per cent
Plus on the next RM 50	Per ton *ad valorem*	15 per cent
Plus on the next RM 50	Per ton *ad valorem*	20 per cent
Plus on the next RM 50	Per ton *ad valorem*	25 per cent
Plus on the balance	Per ton *ad valorem*	30 per cent
Duty exemption formula for palm oil		
Category 1	Export duty	Exemption
	RM 95 and less	100 per cent
	RM 95 - RM 200	.5 (Dp- 95)+ 95 + .35(Dp-Dc)
	RM 200 - RM 365	.35(Dp-200)+147.5 + .35(Dp-Dc)
	RM 365 and above	.2 (Dp-365)+205.25+ .35(Dp-Dc)
Category 2	RM 95 and less	100 per cent
	RM 95 - RM 200	.6 (Dp- 95)+ 95 + .35(Dp-Dc)
	RM 200 - RM 365	.45(Dp-200)+158 + .35(Dp-Dc)
	RM 365 and above	.3 (Dp-365)+232.25+ .35(Dp-Dc)
Category 3	RM 95 and less	100 per cent
	RM 95 - RM 200	.65(Dp- 95)+ 95 + .35(Dp-Dc)
	RM 200 - RM 365	.5 (Dp-200)+163.25+ .35(Dp-Dc)
	RM 365 and above	.35(Dp-365)+245.75+ .35(Dp-Dc)
Category 3a	RM 95 and less	100 per cent
	RM 95 - RM 200	.7 (Dp- 95)+ 95 + .35(Dp-Dc)
	RM 200 - RM 365	.55(Dp-200)+168.5 + .35(Dp-Dc)
	RM 365 and above	.4 (Dp-365)+259.25+ .35(Dp-Dc)
Category 4		Full exemption

Category 1 includes neutralized/refined palm oil, bleached palm oil, crude palm olein, and crude palm stearin;
Category 2 includes neutralized/refined, bleached palm oil, neutralized/refined palm olein, neutralized/refined palm stearin, bleached palm olein, and bleached palm stearin;
Category 3 includes neutralized/refined, bleached & deodorized palm oil, neutralized/refined, bleached palm olein, and neutralized/refined, bleached palm stearin;
Category 3a includes neutralized/refined, bleached & deodorized palm oil;
Category 4 includes neutralized/refined, bleached & deodorized palm olein, and neutralized/refined, bleached & deodorized palm stearin.

Dc = duty on crude palm oil
Dp = duty on processed palm oil

Source: Ministry of Primary Industries, Malaysia (1994b, pp. 47-48)

Table 15: Malaysia's exports of processed palm oil by main destinations, 1980 and 1993

Country	1980		1993	
	'000 tons	per cent	'000 tons	per cent
Total	2086	100.0	5979	100.0
Pakistan	113	5.4	1024	17.1
China	50	2.4	752	12.6
Singapore	650	31.2	526	8.8
Egypt	0	0.0	420	7.0
Japan	142	6.8	334	5.6
USA	120	5.8	258	4.3
European Union	214	10.3	253	4.2
Rep. of Korea	19	0.9	186	3.1
Turkey	0	0.0	185	3.1
Jordan	0	0.0	175	2.9
Saudi Arabia	14	0.7	142	2.4
Indonesia	0	0.0	127	2.1
Yemen	5	0.2	123	2.1
Bangladesh	29	1.4	107	1.8
Australia	43	2.1	89	1.5
India	396	19.0	80	1.3
Iran (Islamic Rep. of)	0	0.0	57	1.0
Mozambique	7	0.3	24	0.4
former USSR, CIS	56	2.7	8	0.1
Iraq	56	2.7	5	0.1
Kenya	9	0.4	2	0.0
Other [1]	165	7.9	833	13.9

[1] The increase in these figures reflects new market developments in such countries as Algeria, South Africa, Brazil and Nigeria.

Source: Hashim (1994).

Table 16: Pre- and post-Uruguay Round tariff escalation in palm-oil trade

Country	Product	Pre-Uruguay Round	Post-Uruguay Round	Percentage change
Japan	Palm stearin	5%	2.5%	50
	Other processed palm oil	7%	3.5%	50
	Crude palm kernel oil	8%	5.6%	30
	Processed palm kernel oil	8%	5.6%	30
	Stearic acid	5%	2.5%	50
European Union	Crude palm oil, technical use	4%	0.0%	100
	Crude palm oil, other use	6%	3.8%	36.6
	Refined palm oil, solid fractions	17%	10.9%	35.9
	Refined palm oil, technical use	8%	5.1%	36.3
	Refined palm oil, other use	14%	9.0%	35.7
	Crude palm kernel oil, technical use	5%	3.2%	36.0
	Crude palm kernel oil, other use	10%	6.4%	36.0
	Refined palm kernel oil, solid fractions	17%	10.9%	35.9
	Refined palm kernel oil, technical use	8%	5.1%	36.3
	Refined palm kernel oil, other use	15%	9.6%	36.0
United States	Crude palm oil	1.1 cents/kg	0.0%	100
	Refined palm oil	1.1 cents/kg	0.0%	100
	Palm kernel oil other than crude and its fractions	6.6 cents/kg	0.0%	100

Source: Othman (1994).

4. The Government's role in market regulation and marketing

94. The Government has played an important role in marketing and market regulation, in addition to its leading role in research and resettlement in the palm oil sector. The Malaysian Palm Oil Pool was established as an association of palm oil producers in 1964. Its main objective was furthering producer cooperation in the penetration of distant world markets. The Pool established a Joint Selling Committee in Europe which controlled marketing and pricing as it was responsible for setting a common selling price for all Malaysian exporters to sell their palm oil. The need for flexibility in pricing grew evident with the increasing size of palm oil exports from Malaysia, as producers and exporters gained experience in striking better deals for their individual exports than the Committee. When the Pool collapsed in 1972, the Malaysian Palm Oil Producers' Association became operative and continued the price equalization process. However, as FELDA remained outside the Association and the rigidity of the pricing system persisted, virtually all sectors of the industry agreed to terminate the pool system of the association in June 1974. Since then, palm oil producers have been free to export on their own at market prices.[38]

95. However, when producers expressed the need for a coordinating body for quality control and market information, the Palm Oil Registration and Licensing Authority (PORLA) was created in 1980. PORLA has been funded by a tax on palm-oil production. Its board of directors is composed of representatives from both the Government and industry. Thus, it provides a forum for cooperation between the Government and the private sector in the palm oil area. Apart from developing new markets[39] and promoting the commodity on export markets, as well as acting as the mediator in contractual disputes between shippers and cosigners, PORLA's main functions have been to attain high quality palm oil exports by establishing quality standards and a grading system, as well as by overseeing the quality of palm-oil exports. It also gathers information on and maintain records of all relevant matters relating to the palm oil industry, and licenses those involved in palm oil trade, with a view to ensuring orderly trading conditions. PORLA has thus neither been directly involved in selling, nor interfered with producers' pricing policies nor used its powers to limit competition. The Malaysian Palm Oil Promotion Council was established in 1990 to initiate and coordinate market development programmes, public relations and promotion, as well as scientific and technical services, with a view to promoting effectively the marketing of Malaysian palm oil.

96. The Government has also actively promoted palm oil exports by offering countries, for example, Pakistan and Algeria, special credit facilities for palm oil imports under the Palm Oil Credit and Payments Arrangement scheme. The Arrangement is designed to promote palm oil exports to developing countries, especially those which are willing to purchase a minimum quantity per year, as specified by the Malaysian Government. Under this scheme, importing countries are able to defer payments for a period of two years.[40]

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[38] In 1980, the Government established the Kuala Lumpur Commodity Exchange (KLCE) which traded palm oil as its first commodity. The exchange is based on self regulation and overseen by the Commodities Trading Commission. The palm oil futures contract has been used mainly for trade within Malaysia.

[39] PORLA was, for example, responsible for the penetration of new markets in the Middle East and Asia which it did mainly through selling missions.

[40] See chapter II section G and Ministry of International Trade and Industry (1994, pp. 143-144) for further details.

5. Conclusion

97. As may be seen in the foregoing discussion, despite the fact that the private sector has operated and managed the Malaysian palm oil sector, government policy has played a key role in the sector's successful development over the last 25 years. Government policy within the framework of the NEP has led to a steep increase in the area planted with oil palms. Government-assisted research has allowed for a surge in plantation productivity, maintenance of the sector's supply capacity and the development of new end-uses for processed palm oil products; investment incentives have provided the financial stimulus for inv stors to take up and expand activities in the palm oil sector; the provision of adequate marketing intelligence and expertise has allowed traditional markets to be maintained and new markets penetrated, including those for processed palm oil products, despite the presence of tariff escalation in industrialized countries. Favourable world market demand and the fact that the prices of palm oil and palm oil products have not been officially controlled over the past 20 years or so have supported these government activities.

C. Cocoa

98. Malaysia started to grow cocoa on a commercial basis in the 1950s. The land area under cocoa plantation was only 2,000 ha in 1960. By 1980, it reached more than 100,000 ha and expanded by about 30 per cent annually in the mid-1980s. Starting from a very low level of production in the mid-1970s, cocoa production increased sharply during the period of high cocoa prices on the world market at the end of the 1970s. The rate of growth slowed during the 1980s, in the face of lower cocoa prices. Nonetheless, by the end of the 1980s, Malaysia evolved as the world's fourth largest cocoa producer, accounting for about 8 per cent of total world cocoa production, the world's third largest exporter of cocoa beans, and the third largest developing-country exporter of cocoa products. More than half of the country's production comes from the Eastern state of Sabah, where cocoa production has played an important role in poverty eradication and the provision of employment in line with the objectives of the NEP. In the states of Sabah and Sarawak, cocoa is grown as a monocrop, while in Peninsular Malaysia smallholders intercrop cocoa with coconut. Estates account for about 80 per cent of cocoa production; smallholders produce about 10 per cent of total output; the remainder comes from the public sector land and resettlement schemes, cooperative farms in Sabah and agriculture diversification schemes in Sarawak. Yields of smallholder cocoa production have been about 30 per cent below that of estates. This is attributed to the fact that estates have been able to apply a scientific and highly disciplined procedure for planting, manuring, drainage, weeding and pruning. Estates have also produced better quality beans, as they have been able to apply proper size grading, cleaning and controlled drying, while smallholders have had problems in adequately controlling the drying and fermentation process.

99. Regarding the institutional set-up in Malaysia's cocoa sector, the Government empowered the Federal Agricultural Marketing Authority (FAMA) to engage in post-harvest extension facilities as well as to license buyers of cocoa and to purchase cocoa beans from smallholders. In 1984, FAMA launched a cocoa grading and certification scheme, with a view to raising the quality consistency. Quality improvements - basically the reduction of acidity with a consequent increase in cocoa flavour - which have resulted from the scheme's operation have made Malaysian cocoa increasingly popular among manufacturers and processors in Europe and the United States. The Malaysian Cocoa Board (MCB), created in 1989, took over a large part of FAMA's responsibilities in the cocoa

sector. FAMA has continued to be the implementing agency for measures designed to improve the quality of smallholder cocoa as well as for the marketing of this produce. MCB's mandate has included the establishment of standards and guidelines regarding grading and certification as well as research and development, registration, licensing and market promotion. In 1991, the MCB adopted the Cocoa (Grading and Licensing) Regulations which allowed for the enforcement throughout Malaysia of compulsory grading of cocoa beans for export. The regulations seek to enable cocoa exporters to ship uniformly the grade of cocoa their customers want.

Table 17: Basic statistics on cocoa, 1977-1993

Year	Planted area (ha)	Production of cocoa beans (tons)	Exports (RM million)				
			Beans	Butter	Powder and paste	Chocolate	Total
1977	48,480	16,700	n.a.	n.a.	n.a.	n.a.	n.a.
1980	123,855	36,500	162	35	3	2	202
1985	297,552	99,000	409	117	16	2	545
1987	341,000 [1]	167,000	684	148	26	6	864
1989	n.a.	243,000	520	241	31	25	725
1990	420,300	247,000	448	241	41	25	755
1991	400,200	230,000	406	243	30	39	720
1992	371,386	220,000	315	239	40	46	641
1993	350,000 [1]	200,000	304	257	52	60	673

[1] estimate

Source: Ministry of Primary Industries (1988a, pp. 52-65; 1988b, pp. 121-122; 1994a, pp. 46-53; 1994b, pp. 91-93)and UNCTAD database.

100. Part of the spectacular increase in production can be attributed to the expansion of total production area, as shown in table 17. This expansion was largely the result of new land development under the NEP and the responsiveness of farmers to high cocoa prices in the world market. Farmers started to grow cocoa in the search for insurance against low rubber prices or, in the case of Sarawak, in response to falling pepper prices. Persistent low cocoa prices during the late 1980s and early 1990s led to the replanting of uneconomic cocoa areas with other crops, such as oil palm, thus demonstrating the high price responsiveness of cocoa growers. The high productivity of cocoa growing was another compelling reason for the steep increase in production during the 1980s. Productivity in the cocoa sector grew by 6 per cent per annum during the 1980s as a result of, for example, improvements in drainage and irrigation facilities, the use of improved plant and seed varieties, and the adoption of improved technologies [Ministry of Agriculture (1993, p. 11)]. The average annual yield in 1991 was 650 to 700 kg per ha, with the most efficient estate producers obtaining 1.5 to 2.0 tons per ha annually, compared to an average annual output of about 500 kg per ha by major producers in West Africa, for example.

101. Research and development activities have also played a crucial role in Malaysia's successful horizontal diversification into cocoa as they have allowed for cocoa growing to become very productive and for substantial quality improvements. Research and development in the cocoa sector had focused for many

years on cultivation techniques with yield increment and reduction of production costs as the main objectives. These activities have, for example, allowed vascular streak disease tolerant, Amazon hybrids to be grown, which have a much higher yield than traditional hybrids. Another result of these activities was the adoption of cloning which allows higher yields to be produced with bigger beans of uniform size, higher fat content and a higher resistance to diseases. Clonal technology also makes it possible to apply systematic selective budgrafting in stages on old plants that have been delivering poor yields so that a holding can continue to produce fruit without any loss owing to replanting. This makes it possible to maintain yields at a relatively stable level. Quality improvements and the application of new processing techniques have made it possible to produce beans with flavour comparable to that of cocoa grown in Ghana. As a result, "Malaysian cocoa on its own could be used to develop products such as chocolate spread, chocolate bar (with different ingredients) and in confectioneries" [Ministry of Primary Industries (1988a, p. 62)]. The Government is now establishing a technology laboratory in the MCB, giving priority to research into processing and product development.

102. Regarding export marketing, prices are freely negotiated between producers, traders and exporters; traders are usually involved only in exports coming from small-holder farmers. The price of dry cocoa beans (spot Ghana prices) in the London terminal market serves as the price reference. The Government has not been involved in export marketing. Producer prices therefore reflect the development on the world cocoa market and usually are at a level of about 70 to 80 per cent of the world market price for standard quality. Quality discounts as well as margins of exporters and other actors involved in the marketing chain account for the remaining 20 to 30 per cent.

103. The production of cocoa beans was given further impetus by the development of highly productive domestic cocoa processing facilities. Table 17 shows that about 30 to 40 per cent of total production has been processed locally in the past few years. A striking feature is that in 1993 export earnings from processed cocoa products actually exceeded those from cocoa beans, and that - like palm oil - vertical diversification has been achieved despite the presence of tariff escalation in the markets of industrialized countries. Research and development activities, stable climatic conditions and a favourable geographical location were deemed main factors behind Malaysia's success in this area. As mentioned above, research and development activities have led to quality improvements and the adoption of new basic processing techniques which have made it possible to produce beans with a flavour comparable to that of the high-quality cocoa grown in Ghana. Malaysia's stable climate has allowed the country to be a reliable source of beans in a market that is subject to large oscillations induced by the cocoa trees' susceptibility to rainfall, hence its attraction for foreign investors (such as Cadbury, Van Houten and Nestlé) in joint ventures in cocoa processing. Investors have also been attracted by the fact that the Malaysian Government has reduced the duty on cocoa imports from 35 per cent to 5 per cent, with a view to facilitating cocoa blending in Malaysia. Marketing arrangements with large foreign firms have allowed traditional markets to be tapped for example, in Europe and the United States, for exports of cocoa butter; Malaysia's geographical location has made it possible for domestic firms to develop chocolate exports to countries in East and West Asia where demand is growing for chocolate-coated convenience food, while the population is less quality-conscious and particularly less brand-conscious than in traditional markets.

104. To summarize, the responsiveness of farmers to high cocoa prices around 1980 and the fact that the Government's activities in research and development

made high-yielding crop hybrids available to cocoa producers and allowed for quality improvements were the main reasons behind the steep rise in production. The higher quality has also allowed cocoa producers to remain competitive in the world market during periods of low prices. Research and development activities leading to quality improvements, stable climatic conditions and the favourable geographical location were among the main attractions for foreign investors and have facilitated Malaysia's success in vertical diversification in the cocoa sector.

D. Forestry products

105. Malaysia is the world's largest producer of tropical hardwood. Forests cover over 60 per cent of the total land area of Peninsular Malaysia, Sabah and Sarawak. The Government has attempted to transform the forestry sector into a major resource-based industry, in order to generate maximum value-added and help establish the country as an important centre for furniture and joinery/mouldings in the world market for wood-based products. Table 18 illustrates the significant increase in exports of sawn timber, plymouth and veneer over the past few years. However, it seems that Malaysia has faced a dilemma in the endeavour to export processed forms of forestry products as world demand and timber prices have been rising in the wake of the imposition of tighter conditions for the export of timber by neighbouring countries. Domestic sawmillers therefore want to export logs to take advantage of high prices on the world market with the result that the downstream manufacturers suffer from a localized shortage of raw materials [UNIDO (1991, p. 92)].

Table 18: Production and exports of major timber products by product group, 1980-1993

A: Production volume ('000 cubic metres)

Year	Sawlogs	Sawn timber	Plywood	Veneer	Moulding	Total
1980	27,916	6,237	500	410	n.a.	35,063
1985	31,419	5,559	551	228	248	38,005
1987	35,613	6,331	863	312	248	43,367
1989	40,812	8,465	1,014	405	254	50,950
1990	40,099	9,156	1,492	478	226	51,451
1991	39,859	8,926	1,606	692	415	51,498
1992	43,512	9,482	2,062	1,302	433	56,791
1993	37,135	9,200	2,765	2,123	494	51,717

B: Export volume and value ('000 cubic metres) (RM million)

	Sawlogs		Sawn timber		Plywood		Veneer		Moulding		Total	
Year	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value
1980	15,086	2,612	3,135	1,211	439	282	112	36	n.a.	212	18,772	4,354
1985	19,771	2,782	2,740	1,009	363	193	440	71	n.a.	227	23,314	4,283
1987	22,853	4,238	3,829	1,680	717	480	493	102	n.a.	315	27,893	6,815
1989	21,110	4,357	5,135	2,945	915	720	248	267	n.a.	519	27,408	8,809
1990	20,354	4,041	5,283	3,071	1,017	863	332	202	n.a.	488	26,986	8,665
1991	19,320	4,097	4,932	2,901	1,186	1,001	477	302	399	543	26,314	8,844
1992	17,797	3,826	5,417	3,409	1,670	1,361	765	491	n.a.	712	25,649	9,800
1993	9,382	2,914	5,371	4,422	2,421	2,660	720	705	n.a.	585	17,894	11,287

Source: Ministry of Primary Industries (1988b, pp. 176-187; 1994b, pp. 146 and 158)

106. Timber processing has been encouraged by the Government's phased approach, gradually imposing a ban on log exports[41] while providing a variety of incentives for processing. In November 1972, the Government introduced a ban on the export of the ten most popular species from Peninsular Malaysia, with the result that the share of exports to production dropped to 7 per cent within one year. In September 1976, a quota for the export of logs with a diameter greater than 16 inches was introduced for all species. Conversely, in Sabah plans announced in 1977 to reduce the exports of logs have never been implemented, as the state's revenues heavily depend on royalties collected from log exports. Sarawak has followed a policy granting 25-year licenses which stipulate that 34 per cent of log production can be exported, 40 per cent has to be used in local saw milling, and 26 per cent must go into plywood and veneer production. The cess rates imposed on exports of forestry products from Peninsular Malaysia in 1993 are shown in table 19. In addition to these cess rates, a levy ranging between 40 - 250 RM/cubic meter depending on the wood species had to be paid on exports of forestry products from Peninsular Malaysia. These duties are not imposed on exports of forest products from Sabah and Sarawak, where exporters, however, have to pay royalties on each tree felled. These royalties are used for financing reforestation programmes. The difference in legal prescriptions regarding log exports is due to the fact that the individual states have sovereignty over the forestry sector.

Table 19: Cess rates on exports of forestry products from Peninsular Malaysia [RM/m3 or part thereof]

Logs	1.36
Sawn timber (rates differ by species)	1.36 - 121.36
Plywood	1.36
Veneer (all species)	121.36
Rubberwood	81.36
Moulding (other than rubberwood)	1.36

Source: Malaysian Timber Industry Board: Management Diary 1995, p. 21

107. There is disagreement as to the effects on the economy of the ban on exporting logs. The World Bank argues that by diverting export sales of the resource onto the home market, export restrictions have lowered the resource's domestic price. This lowered price benefited processors but the Government ran the risk of encouraging inefficient industries which might become permanently dependent on government support. Moreover, the effect of the decline in the domestic price could be divided into the gain accruing to processors and a dead weight loss.[42] Government officials see such calculations as "an accountant's tabulation with no reference to actual market conditions". They argue that

[41] Log exports from Peninsular Malaysia have not been banned completely. One or two per cent of log production is exported to Singapore, in order to have a reference for domestic price negotiations with sawmillers.

[42] For Indonesia, this loss has been estimated as being equivalent, in the mid-1980s, to four dollars in lost log exports for every dollar gained in plywood exports and an accumulated total loss of US$ 2 to 3 billion up to 1987; see GATT (1991, p.178)

continuing to supply the world market with logs at previous logging rates would have created a surplus, resulting in depressed prices and a waste of natural resources (ibid.). They also argue that the calculation was static and did not take into account the fact that prices were dropping only temporarily until domestic processing facilities could be created that would absorb the "oversupply" of logs responsible for the price decline. Regarding domestic log processing in Malaysia, processors were able to produce competitively even after prices for logs had gone up again because of the concomitant increase in prices for plywood in response to the development of plywood exports to Taiwan Province of China, the Republic of Korea and Japan.[43]

108. The profile of timber exports from Peninsular Malaysia differs greatly from that of Sabah and Sarawak, as, in the former, log exports account for less than 2 per cent of total wood exports while the latter two states export between 70 and 90 per cent of their output in the form of logs.[44] The difference in legal provisions regarding log exports is one of the reasons for this disparate in export pattern. Moreover, research and development support for processing has so far focused on Peninsular Malaysia, with the result that the lack of technical know-how regarding production and management control systems in Sabah and Sarawak has constrained the development of processed wood products in these two states. In addition, Sabah's state revenues system is very much dependent on the royalties collected from log shipments and these royalties are levied on shipments to Peninsular Malaysia as well. This makes the logs very expensive for processors located in Peninsular Malaysia. Most of Sabah's log production is therefore exported rather than shipped to Peninsular Malaysia for processing. Finally, wood processing in Sabah has also been constrained by market access barriers to processed wood in Japan, the major destination of log exports from this state. Companies transferring processing sites from Peninsular Malaysia to Sabah or Sarawak have been allowed a 100 per cent Industrial Adjustment Allowance in order to promote a greater regional dispersion of activities in the sector. It seems, however, that this allowance has not been used so far.

109. Furniture exports have increased substantially since the inception of the Industrial Master Plan in 1986, as shown in table 1. Investment incentives associated with the consideration of furniture as a priority area in the IMP have attracted foreign investors to engage in joint ventures. The Government has further sought to stimulate this sector by creating industrial estates where land, electricity and water have been made available cheaply, a one-stop agency for production licenses has been set up, and specific technical training is provided. Linkages between companies producing in these industrial estates and domestic companies outside have been strengthened through the introduction of a vendor scheme, as discussed in box 4.

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[43] Information obtained in an interview with an official of the Malaysian Government.

[44] In 1990, local use of domestic sawn-log production amounted to 50 per cent [Government of Malaysia (1991, p. 35)].

Box 4

Strengthening backward linkages: the Vendor Development Program (VDP)

The VDP was established in 1988 with the objective of strengthening backward linkages mainly between FTZs and the rest of the country by creating an industrial market in which Malaysian small and medium-sized enterprises could become reliable manufacturers and suppliers of industrial inputs, machinery and equipment used by large-scale industry and transnational companies. The VDP was originally established to increase the domestic content of the national car (PROTON) but was extended to the electronics sector in 1992 and to the wood-based industries in 1993. Until 1993, the VDP served as a bilateral arrangement between an anchor company providing the market, technical, managerial and consultancy services, as well as relevant machinery and equipment to the vendor, which in turn produced the input. The VDP is now a tripartite arrangement with the third pole being a financial institution that provides the necessary financial facilities. In 1993, one anchor and five vendor companies had activities in wood-based furniture components [MITI (1994, pp. 258-260)].

110. Regarding export marketing of wood-based products, the Government - through the Malaysian Industry Timber Board (MITB), whose jurisdiction, however, does not extend to Sabah and Sarawak - undertakes promotional activities such as the organization of trade fairs and sales missions and provides advertising services, business contacts and market information to the private sector. Conversely, export marketing as such is done by the private sector, be it by processors themselves or by trading and exporting companies acting on behalf of producers. Regarding log exports, sawmillers are directly involved in all marketing activities, assisted by the MITB.

111. An illustration of cooperation between the private sector and the Government in the forestry sector is given in the example where the Government of Malaysia, in conjunction with other ASEAN countries, had raised a complaint at GATT in 1992 over Austria's mandatory labelling requirement for tropical timber and the creation of a non-mandatory quality mark attesting that tropical timber products came from sustainable forest management. The legislation came into force in September 1992. After discussions in the GATT Council and informal meetings among the interested countries, the Austrian Parliament abolished the mandatory labelling requirement but maintained the voluntary use of the quality mark, "with authorization for its use fulfilling criteria accepted by relevant international organizations" [GATT (1993, p. 177)]. According to the mandatory labelling requirement, an importer wishing to use the quality mark must obtain a license from the Austrian Government which is granted only if the Austrian authorities deem the source of the timber products to satisfy their definition of sustainable forest management.[45] See Annex II for the position of the Government of Malaysia on these issues.

[45] See also GATT: Focus, No. 95, November-December 1992, p. 4.

ANNEX 1: The structure of main incentive schemes

Instrument	Concession
Investment incentives	
Agro-based cooperative societies, associations and sole proprietorships and partnerships in the agricultural sector, companies in the manufacturing sector and small and medium-sized enterprises	
Pioneer status: any company participating in a promoted activity or producing a promoted product;	Exemption from income tax of 70% (100% until 1992) of statutory income for 5 years from the date of production; Government can grant 100% exemption to strategic projects of national importance;
Investment tax allowance: any company participating in a promoted activity or producing a promoted product; alternative to pioneer status;	Allowance of 60% regarding qualifying capital expenditure incurred within 5 years (10 years in agriculture) from the date of approval of the project; allowance can be set off against 70% of the statutory income in the year of assessment;
Companies in the manufacturing sector and agro-based cooperative societies, associations and sole proprietorships and partnerships in the agricultural sector	
Accelerated depreciation allowance: granted to companies established before 1991 in the wood, textile and engineering industries; this scheme is exclusive of other capital or agriculture allowances;	Initial allowance of 20% and annual allowance of 40% for capital expenditure on plant and machinery;
Overseas investment: companies investing in resource-based manufacturing and processing of agricultural products; projects need to be approved by the Government;	Abatement of 50% on income earned from investments abroad and remitted back to Malaysia; dividends paid from tax-exempt income are exempted from income tax for five years; pre-operating expenses incurred, such as for market research, can be deducted for income tax purposes;
Agro-based cooperative societies, associations and sole proprietorships and partnerships in the agricultural sector	
Agriculture allowance: granted for: - expenditure on the clearing and preparation of land, planting of crops and construction of roads for purposes of agriculture; - expenditure on construction of buildings for the welfare of persons or living accommodations; - expenditure on other buildings used for purposes of working a farm;	- 50% of annual expenditure incurred - written off at an annual rate of 20% - written off over a period of 10 years
Companies in the manufacturing sector and small- and medium-sized industries	
Reinvestment allowance: companies that incur, before 31/12/1995 (period extended indefinitely as of 1/1/1994), qualifying capital expenditure for expansion of capacity, modernization and upgrading of production facilities, and diversification into related products;	Tax allowance of 40% of capital expenditure for manufacturing sector and 50% for small- and medium-sized industries; 50% for all companies as of 1/1/1994;

Small and medium-sized enterprises (SMEs)	
Preferential loans: all SMEs taking out loans up to RM 500,000	Soft loans from Government and international financial institutions; commercial loans covered by Principal Guarantee Scheme of Malaysian Credit Guarantee Corporation up to 80% of loan amount;
Concessional financing: - all SMEs engaged in manufacturing, agriculture and tourism; - all SMEs	Granted by ASEAN-Japan Development Fund; Special loan schemes granted by Government through Industrial Adjustment Fund and (for Bumiputera companies) New Entrepreneurs Fund;
Grants: all SMEs engaging in feasibility studies, product development and design, quality improvement and marketing	Extended from Industrial Technical Assistance Fund;
Export incentives in the form of duty and tax concessions	
Tax abatement: granted to resident manufacturing companies exporting, directly or through agents, products manufactured in Malaysia;	Until end-1992, abatement equalled 50% of the ratio of export sales to total sales; in 1993, the abatement was 25%; scheme abolished as of 1/1/1994 because considered as subsidy by GATT
Export allowance: granted to trading companies that export products manufactured in Malaysia or agricultural products approved by MITI;	Until end-1992, allowance equalled 5% of the FOB export value; in 1993, allowance was 3%; scheme abolished as of 1/1/1994;
Double tax deduction: - granted to companies which export to non-traditional markets; - resident companies seeking opportunities for export of products manufactured in Malaysia;	Allowed on premium payments for export credit insurance for non-traditional export markets with a company approved by the Minister of Finance; Allowed on certain expenditures such as overseas advertising, market research, supply of free samples abroad, etc.;
Industrial building allowance: granted for buildings used as warehouses and bulk storage installations for export goods;	Initial allowance of 10% and annual allowance of 2%;
Customs duty exemption: granted to companies manufacturing finished goods for export;	Full exemption of raw materials or components which are not manufactured locally, or are not of acceptable quality and price if produced domestically;
Drawback of duty, excise duty and sales tax: granted for parts, ingredients or packaging material if used in manufacturing of exported goods, including to FTZs;	Full drawback;

Incentives related to training and research and development	
Companies incurring expenditure on buildings used for approved industrial training; Manufacturing companies and SMEs incurring expenditure for approved training;	Industrial building allowance with initial allowance of 10% and annual allowance of 2%; Double tax deduction of operational expenses;
Research allowance: - Research-and-development companies	before 29/10/1993: five years tax exemption; since 29/10/1993: - research allowance equivalent to 100% of qualifying capital expenditure incurred within 10 years; - industrial building allowance; - allowance to be abated to maximum of 70% of statutory income per year;
- companies undertaking in-house research-and-development activities	before 29/10/1993: - industrial building allowance (10% initial and 2% annual allowance); - double deduction on revenue; - exemption of import duty, excise duty and sales tax on machinery, equipment, raw materials etc., used for approved research projects; since 29/10/1993: - research allowance of 50% for qualifying capital expenditure for 10 years; - maximum abatement per year limited to 70% of statutory income;
Sector-specific incentives	
Rubber (operative 1985-1990): Manufacturer of rubber-based products for export purchasing natural rubber from FELDA, MARDEC or RISDA; Manufacturer of rubber-based products;	Discount of 0.20 ringgit per kg; Discount on electricity bill depending on share of exports in total output; maximum discount of 20%;
Rattan and wood-based sector (as of 1990): (1) Manufacturers of rattan and wood-based furniture and components; (2) Companies exporting more than 60% of their component products and with more than 51% Malaysian equity; (3) Manufacturers of rattan and wood-based products (excluding sawn timber and veneer) in Sabah and Sarawak;	(1) Extension of pioneer status for an additional five-year period; (2) Tax incentives as outlined above except for those incentives linked to income; (3) Extension of pioneer status for an additional five-year period; tax incentives as outlined above except for those incentives linked to income; full exemption from import duty and surtax on raw materials and components (for all rattan and wood-based products) to manufacturers producing for the domestic market; double deduction on freight charges;
Incentives related to export finance	
Export credit refinancing allowance *Export credit insurance and guarantee scheme*	see chapter II section G

Sources: Ministry of Finance (1994, pp. 225-235), GATT (1993, pp. 104-112); UNIDO (1991, pp. 142-148); Malaysia Industrial Digest, Oct.-Dec. 1990, p. 4; and Malaysian Manufacturers' Digest, Vol. 11 No.2 p. 9

ANNEX II

Malaysia's views on timber certification and labelling [46]

1. Malaysia is not averse to timber certification. As a major forest country and leading producer and exporter of tropical timber and timber products, Malaysia attaches considerable importance and is not reluctant to discuss and consider the issue of timber certification and labelling.

2. In principle, Malaysia can appreciate the rationale that timber certification and labelling is being advanced in the name of sustainability. However, there are schemes being promoted in some consuming countries ostensibly in the name of sustainability but governed actually by considerations of political and economic expediency. It is even more worrying that some of these schemes are being developed unilaterally to cover tropical timber exclusively, thereby giving its competitors, namely temperate timber and other substitutes, a distinctly unfair advantage. It is essential that any credible and workable timber certification and labelling initiative be based on the genuine need to ensure the sustainability of the world's forests and timber, and not a mask for advancing any ulterior motive in the name of sustainability.

3. To ensure that certification, as a policy instrument, truly contributes to the attainment of sustainable forest management and access to markets, everything must be taken into consideration before any decision is made regarding its implementation. This is to guarantee that in efforts to address the issue of sustainability through certification and labelling, its implementation will not give rise to new problems and complications.

4. The purposes, role and limitation of timber certification and labelling in ensuring and enhancing the sustainability of the world's forests have to be clearly understood. By and large, timber certification and labelling has so far been conceived as a trade policy instrument. Many studies have shown that trade in timber has not contributed significantly to deforestation and the volume of timber entering the international market is very much less than the total volume of global production. Consideration has to be given to the fact that underlying causes of forest degradation and destruction relate more to poverty, indebtedness, under-development, shifting cultivation and the exploitation of wood for fuel. Hence, while trade in sustainably produced timber can contribute directly to the enhancement of the sustainability of the world's forests, the actual role of trade measures and instruments, including certification and labelling, should be viewed within the overall perspective of the complex sustainability issue and in relation to the need for other measures to be implemented as well.

5 In the event that certification and labelling of timbers is deemed desirable and feasible, it is essential that it be made applicable to all types of timbers, while similar and comparable arrangements should be considered for timber substitutes including plastics, aluminium and steel. From the very

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[46] This statement was prepared by the Malaysian authorities in December 1994.

beginning, the issue of sustainability has been unfairly forced upon tropical forests and timber through emotive and exaggerated campaigns. It is no coincidence that many proposals on certification and labelling initiated in consumer countries have focus exclusively on tropical timber. In the run-up to UNCED and throughout the negotiations for a successor agreement to the ITTA 1983, Malaysia has painstakenly fought for the globalization of the sustainability issue to cover all types of forests and timbers as well as the elimination of double standards and discrimination against tropical forests and timber. Any attempt to restrict certification and labelling to tropical timber alone will render the effect discriminatory and make the product less competitive with temperate timber and like products. This will eventually degenerate into a new non-tariff barrier against tropical timber. Moreover, tropical timber accounts for only 10 per cent of the international timber market dominated by temperate timber. Since the bulk of internationally traded timber is non-tropical, it makes sense to attach importance and priority to the certification and labelling of non-tropical timbers.

6. Malaysia is concerned about the proliferation of unilateral proposals on timber certification and labelling. Many proposals have been advanced to suit the needs and interests of the respective initiators. There are many different perceptions and interpretations regarding the issue of sustainability which could easily give rise to conflicts and misunderstandings. First-party efforts by producer countries are often viewed with scepticism and the need for verification has often been emphasized. Third-party initiatives, particularly in consumer countries have been advanced without adequate understanding of the actual situation in producer countries. The overall situation is quite confusing and in need of urgent rectification.

7. Ideally, all existing unilateral efforts should be discontinued and replaced by a single global mechanism which applies to all timber. The mechanism should be agreed to by all relevant parties including Governments, the timber trade, international organizations and non-governmental organizations, from both producing and consuming countries in the true spirit of global partnership and international cooperation. It should also be based on scientific and internationally agreed criteria of sustainability and varying interpretations.

8. A credible and workable timber certification and labelling scheme will require a realistic and suitable time frame for implementation, which shall not be sooner than the objective by which the sustainability of all types of forest is to be attained. In this regard, it appears that the year 2000 has gained increasing acceptance as the year by which the objective of sustainability is to be realized.

9. There seems to be a clear correlation between the comprehensive and effective coverage of a certification scheme and its attendant costs. It cannot be stated with certainty that timber certification and labelling could be self-financing or if the market would be in a position to bear the costs. The prospects for what is referred to as the "green premium" appears to exist in some countries in Europe but not elsewhere. Unless efforts to produce timber from sustainably managed sources are recognized and rewarded through such incentives as the "green premium", the enhancement of sustainable forest management through certification and labelling will be seen more as a stick rather than carrot.

10. The issue regarding timber from conversion forests has to be addressed as it impinges on the right of countries to development. Principle 2(a) of the UNCED Forest Principles proclaims that States have the sovereign and inalienable right to utilize, manage and develop their forests, including the conversion of such areas according to other land-use policies. The concept of conversion forests should, therefore, be viewed as an integral aspect of sustainable forest management which takes into account the right of countries, particularly developing countries with high forest cover, to ear-mark some of their forest areas for conversion to other uses in order to meet future development needs.

11. The role of ITTO in timber certification and labelling is a matter of policy yet to be considered by ITTC. Basically the options range from a direct and proactive role to one which is indirect and ancillary. Consistent with the view that the scope of certification should cover all types of forests, the competence of ITTO in assuming a direct role in timber certification and labelling is presently in doubt, in view of the fact that the existent mandate is restricted to tropical timber and forests. In the meantime, however, ITTO can be usefully involved in providing a forum for its members to exchange views and to review the development of initiatives and proposals regarding timber certification and labelling.

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